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INSURANCE OF PROFITS

BY
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SECOND EDITION

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PREFACE

IN the pages which follow, an attempt has been made to present in a somewhat new light the elemental principles governing the transaction of Profits Insurance.

While the requirements of students for the Chartered Insurance Institute examinations have been kept prominently in mind, it is hoped that this work can claim to be more than a textbook. The aim has been to produce a useful handbook of reference for all who are called upon to handle this particular class of business.

The author gratefully acknowledges the many helpful suggestions and criticisms received whilst the manuscript was in preparation.

A. G. M.

ASHFORD,
MIDDLESEX.

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INSURANCE OF PROFITS

CHAPTER I

Evidence of early demand for Profits Insurance—Beacon Insurance Company—General Indemnity Insurance Company—Chomage insurances—Time loss policies—Use and Occupancy insurances—Introduction of Profits Insurance in its modern form.

ALTHOUGH Profits Insurance, as practised to-day, is comparatively a new-comer among the many forms of insurance protection now available to the public, there is no lack of evidence that there has long existed a demand for such cover, or at any rate a lively appreciation of the limitations of ordinary fire insurance protection.

This is a commercial age, and when all is said and done, a business undertaking is established and conducted, not for the sake of the money that can be invested in it, but rather for what it will yield. To the business man, then, the profits of a business are no less worthy of protection than the material things which he utilizes for the purpose of obtaining those profits, and for the past century at least it has been realized that, valuable as fire insurance is to the commercial community, it does not, by itself, go far enough. It effectively indemnifies against loss through the destruction of or damage to property by fire, and thus adequately protects the capital put *into* a business—so far as that capital is represented by buildings, machinery, stock and the like—but affords no protection whatever in respect of the profits which the business would have yielded had it not been interrupted by fire.

To-day it is clearly recognized that such cover is outside the scope of ordinary fire insurance. The position was defined at law in 1834 when one Wright unsuccessfully sought to maintain (*Wright v. Pole*) that, by insuring "his interest in the 'Ship Inn'" he was entitled to recover under his fire policy, not only the amount of the fire damage which his hostelry unfortunately suffered, but also a further substantial amount for loss of custom or profits sustained whilst it was being rebuilt.

A few years later, in 1847, a similar action was fought in the

Scottish Courts, with the same result, but this case (*Menzies v. North British & Mercantile Insurance Company*) is more enlightening, for the plaintiff elaborated his claim somewhat, thereby leaving us a record of an early endeavour to recover not only net profit, but standing charges as well. The items in dispute were stated as "consequential damage from loss of occupancy whilst the buildings were under repair, loss of profits that might have been made by the occupant at his trade, and wages of servants" which he had to pay during the period of trade dislocation after the fire.

Despite the fact that they were decided so long ago, these two legal cases are not without interest. Their value to us to-day lies not only in the fact that they help to demarcate the sphere of fire insurance, but also that they indicate that even in the early half of the last century it was recognized that something was lacking in the measure of insurance protection then available and that a definite effort was made to transfer to the community, through the application of the insurance principle, the consequential, but none the less real, loss of profits incurred by the individual consequent upon the disturbance of business through fire.

Beacon Insurance Company.

In these enlightened times it is only to be expected that any indications of a possible field for insurance development would quickly inspire the formulation of new forms of protection, and it is worthy of note that this spirit of insurance enterprise is not the monopoly of the present age. Several sporadic attempts were made during the nineteenth century to evolve schemes for the insurance of Profits. In 1821, for instance, the Beacon Fire Insurance Company offered to the public

the insurance of a weekly allowance to tradesmen and others during the period they are deprived by fire of the means of pursuing their usual vocations.

General Indemnity Insurance Company.

In 1853 the General Indemnity Insurance Company issued its prospectus, wherein appeared the following—

The fire department includes a new feature of considerable importance, namely, insurance against loss of business profits in consequence of fire.

Unfortunately we have no information as to the manner in

which the General Indemnity gave effect, or intended to give effect, to this "feature." The path of the pioneer is beset with pitfalls, and these early adventurers into the realm of Consequential Loss ceased to exist after a brief career, and we can only wonder if, and to what extent, their inglorious end was attributable to their experiments in connection with Profits Insurance.

"Chomage" Insurance.

About the year 1860 there was originated in Alsace another definite attempt to meet the need of the commercial community for protection against loss of business through fire. The system still survives on the Continent under the name of Chomage insurances, an expressive French word which indicates "want of work" or "enforced idleness." In this country such insurances are known as "Percentage of Fire Loss" insurances, and their only claim to the consideration of the public is the extreme simplicity of the principle on which they are based, but, divorced from efficacy, simplicity is a doubtful virtue. Briefly, Chomage or "Percentage" policies are founded on the fallacious principle that the extent of a profits loss can be determined by the extent of the fire damage. A separate insurance is effected, over and above the ordinary fire cover, for an amount representing the Insured's profits, and under it he recovers that percentage of the sum insured which the amount of the fire loss bears to the sum insured under the fire policy. If, for instance, a total loss is sustained under the fire policy, the Insured can claim the full sum insured under the "Percentage" policy, irrespective of the extent of the interruption of business occasioned by the fire. Similarly, if a 25 per cent loss is payable under the fire policy, a like percentage is recoverable of the sum insured under the "Percentage" policy.

It needs but little consideration to appreciate that such crude methods cannot satisfactorily be applied to an ordinary trading or industrial undertaking. Instances will readily suggest themselves to illustrate the fact that serious and even total stoppage of earning power can be brought about by comparatively unimportant fire damage. It will be sufficient to cite the following examples—

(a) the destruction of a certain piece of machinery which forms an essential link in a chain of manufacturing processes, thereby necessitating the stoppage of manufacture.

(b) the destruction of the whole stock of an essential ingredient—not easily replaceable—of a proprietary medicine or other preparation.

(c) the destruction of the power-house of a large factory, causing a stoppage of manufacture until an alternative supply is obtained.

(d) the damage by fire, smoke and water of entrance hall of restaurant, cinema, or similar establishment.

The list could be multiplied indefinitely. In connection with practically every business it is possible to point to certain vulnerable property, the destruction of which would involve heavy trading losses quite disproportionate to the extent of the fire loss.

On the other hand, it is possible that extensive fire damage might occur at certain points which would involve only negligible trading loss, as for example if accumulated stocks were destroyed at a time when it would be possible to replace them by ordinary manufacturing methods before the demand for them is likely to arise.

The foregoing will suffice to indicate that in the majority of cases trading loss cannot satisfactorily be measured by the extent of the fire damage. Moreover, it will be apparent that a definite element of moral hazard is introduced if the principle be admitted of paying an arbitrary amount, over and above the extent of the fire damage, irrespective of whether such additional amount is in excess of the trading loss or not.

A typical wording of the contractual clause of the type of policy we are considering would be—

The Insurers will pay to the Assured the same percentage (after due allowance has been made for any salvage) of the sums recoverable by the assured under fire insurance policies covering stock in the premises as the sum insured hereby bears to the total fire insurances covering stock in the premises on the day of the fire.

Of recent years there have been more or less generally imported into such policies certain provisions for obviating, as far as possible, payments to the Insured in excess of actual trading loss sustained. These have been introduced for the protection of the insurers and take the form of (a) an introductory phrase in the policy to the effect that the intention is to "pay to the Assured the loss of profits sustained" *up to* the stated percentage of the fire loss, and (b) a condition that the sum insured does not exceed the amount of the probable annual profits. The effect of these additions is to lift the policies out of the category of valued contracts, but they

do nothing towards converting them into effective instruments for the measurement of loss and for the indemnity of the Insured.

Despite the simplicity of the contracts, Percentage policies have contributed their quota of Court cases, and the following are among the best known decisions affecting such insurances—

WYLIE HILL v. "PROFITS & INCOME."

In this case the plaintiffs claimed in the Scottish Courts, in 1904, an amount based on the stated percentage of the sum recovered in respect of fire damage. The defendants contended that the percentage mentioned in the policy represented the maximum liability and that they were liable to indemnify the defendants only for actual trading loss sustained. The case was dismissed on the grounds that it had not first been referred to arbitration in the terms of the policy, the Judge stating that he could not accept the view that the amount due was not open to dispute.

STAVERS & STAVERS v. MOUNTAIN.

It was contended by the Insurers in this case, in 1912, that the business was being run at a loss when the insurance was effected, the fact not being disclosed. This was disputed. The Court held that the business was not being conducted at a loss and gave judgment for the plaintiffs.

BRUNTON v. MARSHALL.

In this case (1922) the plaintiffs contended that the policy was a valued contract, and that the condition thereon that the sum insured should not exceed the annual profits did not apply. It was held that the Insurers were entitled to ascertain the annual profits of the business and reduce the amount payable if the risk were over-insured.

In connection with specific "parcels" of merchandise in public warehouses, it is not unusual to issue to merchants—in conjunction with the fire cover—a Percentage of Fire Loss policy limited to 10 per cent of the amount of the fire loss. These insurances are based on the assumption that if such merchandise be destroyed the owner loses the profit which he would probably have earned by their subsequent sale, but the extent of that profit, of course, cannot definitely be established, seeing that, because of the fire, no sale can be effected. It is only by this rough-and-ready method that the merchant can seek to recoup himself for the loss of sale, but it should be noted that the policies referred to invariably relate to merchandise not in the owner's personal custody.

Time Loss Policies.

Another attempt to deal with the problem of Profits insurance—and one which constituted a definite improvement on the Percentage of Fire Loss method—resulted in the introduction of what is known in this country as the Time Loss policy. In effect it is an extension

of the principle of the rent clause in a fire policy. The insurance is effected for an amount equal to the annual profits of the business, and the Insured is entitled to recover in respect of each day's total stoppage through fire the amount arrived at by dividing the sum insured by the number of working days in a year. The policy reads somewhat as follows—

The Insurer will pay to the assured for a period not exceeding twelve consecutive calendar months from the date of the fire in respect of each day during which the business is totally stopped by the fire one three-hundredth part of the sum hereby insured (or one three-hundredth part of the annual profits of the business, whichever shall be the less) and proportionately for each day of partial stoppage.

Assuming annual profits of £30,000 and a sum insured of the same amount, with 300 working days per year, an amount of £100 would be recoverable by the Insured for each working day during which the business is totally stopped by fire. In the event of partial interruption, the £100 per day would be "proportionately" reduced.

The obvious weakness of such contracts lies in the fact that most businesses are to some extent seasonal in character, and in many of them this feature is prominent. In all such cases a day's stoppage of work in the busy season would be more costly to the Insured than a similar stoppage in the slack season, and it would therefore depend upon the time of the year when the fire occurred as to whether the amount payable under such a policy represented more or less than the actual amount of loss.

It is in connection with partial losses, however, that the type of contract we are considering leaves most to be desired, for beyond stating that a partial stoppage of work shall entitle the Insured to a proportionate part of the daily amount, they ordinarily embody no satisfactory provision for measuring the extent of the stoppage—the degree of the interruption. Not infrequently the occurrence of a fire involves no total stoppage at all, but it is obvious that heavy losses can be incurred through prolonged periods of partial stoppage; periods during which business is seriously interfered with, but does not entirely cease. Similarly, a period of total stoppage is almost invariably followed by one of partial interruption during which the business is being reorganized and built up again. The indemnity due to the Insured in respect of such periods is likely to represent a substantial part of the total, and it is important that there should

exist no doubt as to the means by which such partial losses shall be measured. At a later stage we will consider in some detail what will be apparent even at this juncture, namely, that partial interruptions of business can legitimately be measured by many different standards. The omission to deal specifically with the point should be noted as it is likely to be fruitful of dispute.

Use and Occupancy Insurance.

In America this type of policy has been extensively developed under the title of "Use and Occupancy" insurance. To meet the case of seasonal businesses, special policies are utilized for what are termed "fluctuating" risks, a different *per diem* liability being specified in respect of every month, if necessary, of the year, whilst for those risks which are idle during certain seasons of the year (such as canning and ice factories), the actual daily results of the business in the corresponding period of the previous year furnish the maximum *per diem* liability under the policy.

Even with these additional refinements, such contracts appear to be arbitrary and inelastic as regards the maximum daily amount recoverable thereunder. True, the policies protect the Insurers against the possibility of paying an amount in excess of the Insured's actual loss, for the contracts limit liability to "actual loss sustained," but the stipulated daily maxima must operate to the detriment of the Insured if, after a fire, the progress of the business varies—as well it may—from the "programme" set out in the policy. The position might well arise in which the Insured would be unable to prove a loss up to the daily maximum for a part of the period of interruption (in which case he would be entitled only to the amount of his proved loss), whilst for the remaining part of the period he could adduce evidence that his loss exceeded the stated *per diem* liability. Despite the fact that his total sum insured correctly represented his annual profits, he would appear to be precluded, in the circumstances we have assumed, from recovering his full loss under the strict terms of the policy. Needless to say, a great deal will depend upon the spirit in which the contract is interpreted, but at the moment we are concerned with the actual terms of the policy.

A further development to be noted in the modern "Use and

Occupancy " policy is the more specific nature of the provision governing indemnity for partial stoppage. Some definite basis embodied for determining the extent of the interruption, but should not be overlooked that the proportion so arrived at is applied to the arbitrary maximum liability applicable to each day of total suspension.

The American policy is lengthy and somewhat disjointed in character. It is not, in fact, a policy at all, but a schedule for issue in conjunction with the standard fire policy of the United States of America. Its essential portions are reproduced in Appendix and it will be observed that several features are embodied which are at variance with our own ideas on the subject of profits insurance. For instance, it is by no means clear that the Insured is to be indemnified in respect of the heavy additional cost which may be incurred in giving effect to the reasonable policy condition that the Insured shall make use of other premises, if obtainable, while his own are out of use. In British policies prominence is given to this important part of the indemnity they afford.

The " Time Loss " policy marked a definite stage in the history of our subject, and for this reason it has been dealt with at some length. It is curious to note that our American cousins have been content to mould and develop the principle on which such insurances are based, whereas in this and other countries such contracts have been practically abandoned for nearly a quarter of a century.

Modern form of Profits Insurance.

The Profits policy, as it is known to-day, dates its existence from the year 1899, when Mr. Ludovig Mann devised a practical scheme for the measurement of profits losses and thereby made it possible for the true principles of insurance to be applied to *earning power*. The more important provisions of the earlier policies based upon Mr. Mann's scheme are shown in Appendix II, and it will be seen that the amount of indemnity is definitely based on the extent to which business is lost as the result of fire. Due recognition was given to the fact that any pre-agreed basis of settlement may be upset by extraordinary happenings, either before or after the fire, and that, for the maintenance of the principle of indemnity, such circumstances must be met by an appropriate adjustment of amount.

Insurances on this basis seem first to have been issued by the Acme Insurance Company, which was established in 1896 to undertake general insurance business. In 1900 it transferred its fire business to the Western Insurance Company with the declared object of concentrating its attention on Profits Insurance. In the following year it ceased to exist. The profits business was transferred to the Profits and Income Insurance Company, which did much to develop the general lines on which this class of insurance is transacted, and, finally, in 1907 the profits section of the latter Company's business was transferred to the then newly formed Legal Insurance Company.

In 1908 most of the Companies decided to undertake profits business, and thus, although much still remains to be done in the direction of popularizing it, Profits Insurance has long ceased to be a novelty. Traders and manufacturers are awakening to a recognition that it affords a valuable and necessary protection, and a substantial volume of business is now undertaken, both at home and abroad. Needless to say, the modern profits policy bears very little resemblance to the form of contract under which the business was undertaken in the early days of the "Acme," but its basic principle, namely the measurement of loss by the diminution of business activity, is maintained.

CHAPTER II

Trading loss—Net profit and standing charges—Increase in cost of working—
Nomenclature—Consequential losses not covered by profits policies—
Effect of reduced turnover on earning power—Seasonal fluctuations and
standing charges.

PROPERLY to appreciate the principles of Profits Insurance we must keep prominently in mind that its purpose is to indemnify in respect of trading losses—and trading losses only. From an insurance point of view a trading loss is one which arises solely and directly from a *falling off of business*—from a loss of trade—and at this juncture it would be well to consider exactly what financial effect is produced by a curtailment of business activity through fire. At the moment it will be sufficient briefly to specify the headings under which loss is directly produced as the natural result of a diminution of business, whether from fire or any other cause.

Net Profit and Standing Charges.

Seeing that the ultimate purpose of business is the production of net profit, it will be apparent that any interruption thereof will eliminate the net profit which would otherwise have been earned during the period in question. Similarly, if the business is not actually interrupted but is merely reduced, it is in the net profit that we should naturally expect to trace the results of such deviation from the normal course of events. And we shall not look in vain, for the loss so incurred will, in fact, be more serious than might at first seem probable. As business commences to fall away, net profit will assuredly dwindle at a rate even more rapid than that at which the business dwindles until there is reached a point at which, although a large volume of business may perhaps still be transacted, no net profit is being earned. Any reduction of business below that level, will, of course, result in a net loss. The reason for this well-understood principle of business is that it is impossible to reduce, proportionately to any reduction of trading, certain essential charges and expenses inseparable from the conduct of business, such as rents, rates, salaries and so forth. It follows, therefore, that the burden of such expenses will bear more heavily

on the reduced amount of business transacted than it would if the full volume of business were being done. The ratio of these charges will be automatically increased, solely by reason of the reduction in the volume of business, and such increase in the ratio of expenses must have the effect of reducing the profit earning capacity of the remaining business—if, indeed, it does not result in the production of a net loss.

The direct effect, therefore, of a shortage of business is a curtailment or loss of net profit, and we see that such loss is not limited to the proportionate part of the normal net profit which the *business lost* bears to the volume of business ordinarily transacted, for the loss is aggravated and accelerated by an automatic increase in the ratio of standing charges. The loss, in fact, is clearly divisible under two headings—firstly, the net profit which the business lost would ordinarily have contributed had the normal volume of business been maintained; and, secondly, the proportionate part of the standing charges which would in the ordinary course of events have been properly allocable to the amount of business lost, but which, in consequence of the reduction of business, must be borne by such business as is maintained.

Increase in Cost of Working.

This is true trading loss, within the meaning of the term from a Profits Insurance point of view; namely, loss in respect of net profit and standing charges brought about by the reduction or cessation of business. But in the endeavour to minimize such trading loss, certain additional expenses may be incurred with the object of maintaining business under abnormal conditions. We have seen that trading loss is automatically incurred by a reduction in business, and it follows that such automatic loss is avoided if by any means it is possible to maintain business at its normal level, but in its place we probably substitute another form of loss, namely, *the additional cost of keeping business at its ordinary level under abnormal conditions*. The additional rent of temporary premises constitutes a typical item of the class of expenditure we are now considering. The position may arise when serious trading loss can be avoided or diminished by adopting some temporary expedient. The nature of the business may be such that it can be transacted

from any suitable temporary premises that may be available, and if the rent of such premises is substantially less than the amount of trading loss that would otherwise be incurred, obviously it is a sound business proposition to incur the additional expenditure for rent and so avoid the greater loss. It will be apparent, however, that in such circumstances the volume of business which is conducted from the temporary premises is loaded with an abnormal item of expense which, but for the fire, would never have been incurred, namely, the additional cost of measures adopted to avoid or diminish trading losses.

Perhaps the position will be made clearer if we assume that a certain business is totally stopped by fire for a period of six months. In such an eventuality it is clear that the loss incurred will resolve itself into

(a) the amount of the net profit which the business would have earned during that period, plus

(b) the total amount of the charges incurred allocable to the same period.

The question of additional expenditure incurred to maintain the business will not arise, seeing that if no business whatever is transacted, no extra expenditure can have been occasioned.

At the end of the six months' interruption, we will assume that arrangements are completed whereby the normal volume of business is thereafter maintained under certain abnormal conditions. It may be that a temporary agreement has been made with another manufacturer to undertake, for a consideration, the whole of the work usually done in the fire damaged premises. The losses under (a) and (b) will, therefore, cease forthwith, and for the period covered by the temporary arrangement the loss is represented by

(c) the additional cost of getting work done elsewhere.

For the sake of simplicity, we have postulated circumstances that are not likely to arise, viz. : the total cessation of business for a considerable period, and its sudden full resumption under conditions which are not normal to its ordinary conduct. It is far more likely that the period of total stoppage would be followed by one during which the business was being gradually built up again—a period during which losses would be simultaneously incurred under all three heads, but despite its artificiality, our hypothetical case has served its purpose, in that it enables us now to formulate

the scope and purpose of Profits Insurance. This may briefly be stated as follows—

- (a) to make good the loss of net profit due to the interruption of business by fire,
- (b) to meet the payment of the standing charges which continue, and
- (c) to defray the additional expenses incurred to maintain the business

during the period in which business is interrupted or interfered with by fire.

It should be noted that the subject-matter of Profits Insurance is the *business* of the Insured—not his goods. Profits Insurance does not relate to property, but merely to the earning power associated with property. Consequently Profits Insurance does not in any sense purport to indemnify the insured for the value of goods damaged or destroyed, even though they may be lost in consequence of, but not actually by fire. The direct financial loss caused by the destruction of or damage to property is a Capital loss. If goods are rendered valueless—whatever the cause—there has been lost the capital expended in purchasing or producing them. Profits Insurance concerns itself only with the trading loss incurred directly in consequence of a capital loss happening through a certain eventuality, viz.—fire.

Nomenclature.

Failure to discriminate between capital and trading loss gives rise to a good deal of the misunderstanding that arises in connection with the scope of the cover afforded by Profits Insurance. It is, perhaps, a pity that the nomenclature of the business was not more definitely and happily dealt with in its earlier days. Even now, although the offices have freely been transacting Profits Insurance for nearly twenty years, it is offered to the public under such widely differing names as “Consequential Loss Insurance,” “Insurance against Loss of Profits through Fire,” “Loss of Profits Insurance,” or—more crisply—“Profits Insurance.” It cannot be doubted that the business has suffered through the lack of an apt and expressive title. The term “Consequential Loss,” though sonorous, is a forbidding one. It is almost as inartistic as the American “Use and Occupancy.” Moreover, it is apt to convey to the lay mind the false impression that the cover is much wider than

it is in reality. Perhaps it has given rise to the idea—not infrequently expressed—that a Consequential Loss policy affords a useful, omnibus sort of cover that will providentially fill the breach whenever a loss is occasioned by fire—however indirectly—which cannot be recovered under a fire policy. “Consequential Loss” is a very wide term, and even if we limit its application to losses consequential upon fire damage, there are many items of loss which can be properly so called, but which are nevertheless beyond the present scope of both fire and profits policies.

Consequential Losses Not Covered by Profits Policies.

The following examples will serve to illustrate—

1. Loss incurred through under-insurance in connection with fire policies.

A profits policy is not an excess fire insurance. In any event, loss incurred through the destruction of goods by fire is obviously a capital loss, and if under-insurance exists, thereby causing loss to the Insured, it is merely a question of the sharing of a capital loss between insured and insurer.

2. Depreciation of stock consequent upon fire.

It occasionally happens that goods of a perishable nature are spoilt, or depreciated in value, because of inability to deal with them in consequence of fire. The loss is a capital one, just as much as if the property had been destroyed by the fire itself. The *value* of property so damaged or destroyed is, therefore, not recoverable under a profits policy, but only the loss of trading profits so incurred.

3. Difference between values at time of fire and time of replacement.

A profits policy is not intended to be a “replacement” policy. Special insurances can be arranged in certain circumstances to deal with the position. The loss is a capital one, aggravated by adverse market conditions after the fire.

4. Third party and similar claims arising out of the fire.

5. Litigation costs and expenses incurred in preparation of fire claims.

These call for no comment. They are obviously not trading losses, but are certainly “consequential” upon the happening of fire.

But if the term “Consequential Loss” is apt to convey to the uninitiated an impression that the cover afforded by such policies is wider than it really is, certainly any title which relies upon the word “Profits” to indicate the scope of the insurances must err in the opposite direction. To the “man in the street” the word “profits” has one meaning only. It indicates that very important part of his turnover which he retains in his own pocket, or which remains in the coffers of a trading concern for distribution to partners

or shareholders. Despite its paramount importance, however, the business man cannot fail to recognize that in the event of a dislocation of business, a substantial part of his loss—probably by far the greater part of it—is likely to be incurred in connection with the increased ratio of his standing charges, and the costly efforts he must exert to keep his business together if he is to prevent it vanishing for all time. The use of the term “ profits ” may lead him to think that the form of insurance to which it has been applied goes only a small way to meet his requirements, for it can scarcely be regarded as sufficiently comprehensive to denote all—or even nearly all—that is implied by its use in the insurance sense. A process of logical argument is involved in an appreciation of the fact that, for the proper protection of Profit, provision must necessarily be made for Standing Charges and additional expenses incurred to maintain business. However, despite its limitations, the business is now conducted more or less generally under the title of “ Profits Insurance.”

Business Principles.

It will be appropriate now to examine in closer detail the elementary and somewhat obvious principles on which commerce is conducted. The *business* of the Insured is the subject-matter of Profits Insurance, and a clear appreciation of the elements of business is, therefore, just as essential to the study of Profits Insurance as a knowledge of, say, Building Construction is in connection with Fire Insurance.

The conduct of every business necessarily involves a certain amount of expenditure for purchases and service, and its profit earning capacity depends entirely upon its ability to produce money receipts greater than the total of all such expenses. The margin between the total receipts and all the expenditure which has to be met out of those receipts represents the profit of the business, and it necessarily follows that the total of the expenses and of the profit, if any, equals the amount of the receipts. In other words, the receipts of the business are allocable as follows—

Profit

Expenses.

Now the items of expense that are incurred in the ordinary course

of business are many and varied. Obviously their nature will depend upon the type of the business carried on, but for our present purpose we can divide them into two categories—

- (a) those which, from their nature, are variable in amount proportionately to the amount of business done (e.g. purchases of raw material), and
- (b) those which are fixed in amount, irrespective of the volume of business transacted (e.g. rent, salaries), or which cannot be reduced in amount proportionately to any reduction of business.

For the moment we will not discuss the various components of expenditure, or the factors which must be taken into account in considering into which category they fall. At this juncture we can simply regard each item of expense as allocable to either one or the other.

Effect of Reduced Turnover on Earning Power.

We will first consider those expenses which are proportionately variable in amount. If any particular item can be reduced in proportion to a falling off of business; if, in other words, the ratio that it normally bears to the total receipts of the business is constant, irrespective of any diminution in receipts, then no loss will be sustained in respect of that expense when business falls away in consequence of fire, and, therefore, from an insurance point of view, it ceases to interest us. To exemplify the point, we will assume that a series of transactions is being conducted by a quixotic individual who sees fit to buy goods at a certain price and sell them again at the same figure. If a fire should interrupt these proceedings—which we cannot very well term a business—he incurs no loss, for his purchases are governed by the extent of his sales. If his turnover falls, his expenditure is reduced by the same amount and so, whatever we may think of his business acumen, we must admit that he is in a fortunate position in the event of a fire, for he stands to incur no trading loss whatever. Assume, however, that in the fullness of time, he introduces a more commercial element into his transactions. He finds it necessary, perhaps, to rent premises from which to conduct his operations, and accordingly obtains suitable accommodation for £500 per annum. To recoup himself for this item of expense he decides to adjust his selling price to a figure which, at the end of the year, will give him the necessary margin, over and above the cost of

his purchases. We will assume a normal turnover of £10,000, and this enables us to summarize his transactions for the year as follows—

To purchases	£ 9,500	By sales	£ 10,000
„ rent	500		
	<u>£10,000</u>		<u>£10,000</u>

It will be noted that he now incurs an item of expense which cannot be reduced proportionately to any reduction in turnover, and if a fire caused a total interruption of business for a whole year, the whole of that expense would be a dead loss to him. If, however, instead of stopping the whole of his operations, it caused him to curtail them by, say, 10 per cent, the position would be as follows—

To purchases	£ 8,550	By sales	£ 9,000
„ rent	500	„ net loss	50
	<u>£9,050</u>		<u>£9,050</u>

We observe that a 10 per cent reduction of sales has resulted in a net loss equal to 10 per cent of the charges which continued, and it would accordingly be fair to assert that, as a normal turnover £10,000 is sufficient to earn the annual rent of £500, each £100 of turnover contributes £5 towards that charge. It follows that 5 per cent of the turnover that is lost in consequence of the fire represents loss in respect of rent.

To continue our illustration, we may safely assume that, after the interruption caused by the fire had ceased, the generous terms offered to the public resulted in a rapid expansion of sales. We find that, without incurring any increased expenditure—for the premises already rented are commodious—the turnover is quickly doubled, and, consequently, the proprietor finds himself—doubtless to his own surprise and embarrassment—in possession of a business which yields a net profit of £500, for the position now automatically becomes—

To purchases	£ 19,000	By sales	£ 20,000
„ rent	500		
„ net profit	500		
	<u>£20,000</u>		<u>£20,000</u>

If his business should now be interrupted by fire, it becomes a matter of greater concern to him, seeing that he has at stake both his net profit and his annual rent. A total interruption at this stage for a whole year would involve a loss of £1,000, but the loss of £1,000 of turnover would yield the following result—

To purchases	£ 18,050	By sales	£ 19,000
„ rent	500		
„ net profit	450		
	<u>£19,000</u>		<u>£19,000</u>

We see that, despite the large increase in turnover since last we considered the effect of a stoppage, the loss sustained still represents 5 per cent of the shortage in turnover. Since a net profit of £450 only is earned, whereas a surplus of £500 would have been shown in normal circumstances, there is a loss of £50, the whole of which is shown in the accounts under the heading of net profit. The increased ratio of rent to turnover is not specifically shown in the simple form of account we have utilized, but it has occurred, nevertheless. The loss has been actually *sustained* in connection both with net profit—on which the normal ratio of $2\frac{1}{2}$ per cent on turnover has not been maintained—and standing charges, on which the ratio has increased. On a turnover of £20,000, $2\frac{1}{2}$ per cent is sufficient to pay the standing charges (in this case, rent only) leaving $2\frac{1}{2}$ per cent for profit. Following a loss of turnover of £1,000, we can, therefore, view the matter in the light that the actual loss is incurred, as under—

Loss in respect of standing charges (rent)	£ 25
Loss of net profit	25
	<u>£50</u>

To simplify our calculations, we can say that, in respect of net profit *and* standing charges together, the loss represents 5 per cent of the shortage in turnover. That ratio of earning power—and, therefore, that ratio of loss in respect of any falling off of turnover—must always obtain, irrespective of the amount of business done, *so long as the purchases represent 95 per cent of sales.*

It is often possible to convey the essential idea of a simple principle more clearly by means of a diagram than by written explanation and arithmetical illustration. We will abandon the mythical individual whose fortunes we have hitherto followed, and assume subdivisions of turnover more appropriate to modern business conditions. We will take as an example for our diagram the case of a merchant who buys a certain commodity in large quantities and retails it through the medium of an extensive distributing organization. This naturally involves him in heavy standing charges, for his rents, salaries, advertising contracts, and so forth, necessarily represent an important part of his turnover. We will assume, however, that he succeeds on a normal volume of business, in making the substantial net profit of 10 per cent on his turnover. We will first show the manner in which his normal turnover is divided under the three headings—

Variable charges

Standing charges

Net profit

whilst the business is being conducted under normal conditions, and then diagrammatically review the vicissitudes of the business, from a profit-earning standpoint, at different stages of its subsequent diminution. We shall see that its *earning capacity*—its ability to produce a surplus for the payment of standing charges and net profit—varies in strict proportion to the amount of business done, from which we can logically assert that the cash value of business *lost* through fire can be measured accurately by the application of the same principle.

The volume of business normally done in the course of a year is represented by the vertical line at *A* (Fig. 1). The oblique line *A—E* represents the turnover of the business in its passage from normal to zero, and we will consider the financial effect of the reduced turnover at different stages. We will not attach specific values to the line *A—E*, but will view it relatively throughout.

When business is maintained at its normal level indicated at *A*, we see that it yields a net profit of 10 per cent after all standing charges, consuming 30 per cent, have been met. Its total earning capacity, therefore, in respect of net profit and standing charges, is 40 per cent.

When turnover falls to the level marked *B*, the business ceases to earn net profit. The variable charges, which are still maintained at 60 per cent of the sales, are reduced in amount proportionately to the reduction of business, which means that the standing charges—which at this stage exhaust the remainder of the turnover—must represent 40 per cent of turnover. This constitutes the earning capacity of the business at this point, i.e. its ability to meet its standing charges.

When the level of *C* is reached, we note that the business cannot yield sufficient to meet its Standing charges, and that a net loss

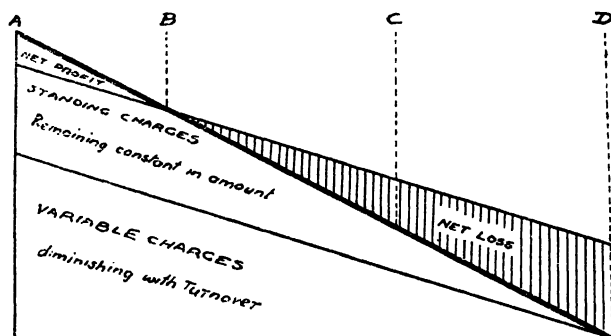


FIG. 1

is produced. Again, the variable charges are proportionately reduced in amount, being still maintained at 60 per cent. The remaining 40 per cent is available for standing charges, but is not sufficient to meet them fully. It is, nevertheless, still true to say that the proportion of the standing charges which is being *earned* by the business at this stage represents 40 per cent of the turnover. Its earning capacity in fact, must remain constant throughout, until, at the point *D* no business is being done. The earning capacity of the business at this final stage is, therefore, *nil*. Not only is no net profit being earned, but the business produces a net loss equal to the total of the standing charges payable.

Some apology would be necessary for the amount of emphasis that has been laid upon the unchanging ratio of earning power, were it not for the fact that a great deal of the misconception that so frequently arises in connection with Profits Insurance is directly

attributable to a failure to grasp the almost self-evident principle that has been demonstrated above. It is, however, amazingly simple and we will summarize it in this manner.

If, despite any fluctuations that may occur in the turnover, some of its constituents can—from their nature—be maintained at a constant ratio to the whole, it necessarily follows that the remaining constituents, *taken together*, must also remain proportionately constant.

If one constituent—the variable charges—continues at, say, 60 per cent of the whole, the remainder—the standing charges *earned* and the residual net profit, if any—must necessarily constitute 40 per cent of the whole. It is merely a matter of subtraction.

It is true that it may not always be easy to divide the charges of a business into the clear-cut categories that we have outlined. The list of expenses ordinarily incurred in the conduct of a business may comprise several items which are not easily allocable, for some of them may be such that, whilst they can be substantially reduced in the event of a reduction of business, they cannot be reduced proportionately to the fall in turnover. It may be that other items can be eliminated entirely if business is totally stopped, but cannot be reduced in amount so long as any business is being transacted. We can consider such items in detail at a later stage, but the existence of doubtful and border-line cases does not weaken the principle. It merely makes its application a little more difficult.

Seasonal Fluctuations and Standing Charges.

Perhaps it will help to illustrate the unchanging ratio of earning power to turnover—and the consequent equity of basing Profits Insurance on that feature—if we consider somewhat closely the effect which a fluctuating or seasonal turnover has on the ultimate profit-earning capacity of a business. It is no uncommon thing for the proprietor of a seasonal business to regard as the most profitable that part of his business he transacts during his busy season. And this is not unnatural, for he cannot overlook the fact that it certainly yields him a greater margin of net profit than does the business he carries on during the quieter periods of the year. Pursuing the same line of thought, he is perhaps apt to consider that a loss of business during his busy season will involve him in a heavier ratio of loss than if it had occurred at another time of the year, and inferentially that Profits Insurance, to be thoroughly

effective, should make some differentiation of ratio, varying with the seasonal fluctuations.

In order to appreciate the fallacy of such a contention, we must give consideration to the general subject of standing charges—those expenses which are *not* variable proportionately to the amount of business done. These charges are generally of such a nature that they fall due for payment at regular intervals throughout the year, and in equal instalments. Salaries will probably be payable monthly; rent and rates may be demanded quarterly or half-yearly and so on; nevertheless, it is the *annual total* of all such charges which alone concerns us when we consider them in relation to the earning power of the business. The fact that they accrue in equal parts at intervals throughout the year is immaterial. The earning power of a business is dependent upon its ability to produce receipts, during the year, in excess of all the outgoings during the same period.

In a previous example, rent has served us as an instance of the charges which cannot be varied proportionately to any falling off of business, and we will utilize it again to illustrate the present point. The landlord sets an annual value on his premises and contracts with his tenant to allow him the use of them in consideration of the payment of that rental. If the business to be carried on is at all seasonal in character, it is quite obvious that the premises will be of greater value to the tenant during the busy quarters of the year than they will during those quarters which represent his slack season, but it is customary, nevertheless, for the rent to be payable to the landlord in equal quarterly instalments. In one quarter the tenant may be paying as rent more than the premises are worth to him from a business point of view, and in another he may be paying less than their actual business value, but in considering the value of the tenancy he must obviously take into account the *annual* rent and the *annual* earning capacity of the business. It may be, indeed, that the business is regularly closed down for a certain part of the year. In certain seaside resorts it is no uncommon thing for this to be done during the winter months. To all intents and purposes, the premises will be valueless to the tenant for those particular periods if considered without regard to the active seasons of the year. He would willingly surrender his occupancy of the premises during the time his business

is closed, if by so doing he could escape liability for the payment of a proportionate part of the annual rent, and provided, of course, that he could regain occupation when he needed the premises again for the reopening of his business. But such a suggestion would not be likely to commend itself to the landlord, who looks for payments throughout the year which will aggregate the annual rental value. If a tenant should occupy the premises for, say, nine months only in each year, it is possible that an obliging landlord might be induced to receive his rent on three quarter days only, instead of four, but in that case he would expect one-third of the annual rent at each instalment, instead of one quarter of it. No one would be inclined to challenge the equity of that.

But if the point were carried still farther, the tenant might find that, of the three quarters of the year during which he proposed to conduct his business from the premises, the second quarter was by far the most profitable to him, in that he actually transacted, during that period, no less than one-half of his total business; in other words, the business of that one quarter might prove to be as profitable to the tenant as the combined business of the other two quarters. If the proprietor of the premises were of a really accommodating disposition, he might be willing to fall in with his tenant's suggestion that the principle already conceded be carried a little further and that *one-half* of the annual rent should accordingly be payable on the appropriate quarter day corresponding with the busy season, and a quarter of it on each of the remaining two, the annual total remaining unaltered. The rent would then be divisible throughout the different quarters proportionately to earning power. The seasonal character of a business transacted from his premises is, however, no concern of the landlord. It cannot affect the annual rental value of the premises. It affects only the manner in which the rent—and other charges—is earned by the tenant at his business and, as we know, usage dictates that these be payable yearly or in equal instalments throughout the year.

The same principle applies to other items of standing charges. Salaries of permanent staff are payable at a constant rate throughout the year, during busy season and slack season, but they are obviously earned more during the busy season than at other times—both by the business and by the employee.

If, by its very nature, a business must be seasonal in character, the proprietor has no alternative but to carry it on through the slack seasons if he seeks to benefit by its busy seasons. In judging the earning power of the business, all seasons must be taken into account, and regard must be had to its results over the whole year. It is the surplus of receipts over expenditure at the end of the year that is of real significance; not the losses of one month or the gains of another. The annual net profit is dependent upon the attainment of a certain volume of business over the whole period, irrespective of whether that business is transacted in equal parts throughout each month of the year, or whether it is achieved in one single transaction or concentrated into one or more brief periods during the year.

Let us take an example and portray it diagrammatically. We will consider the case of a fancy goods dealer operating at one of the East Coast seaside resorts. He caters almost exclusively for holiday makers and therefore closes his business during the winter months. His rent, rates and other standing charges, of course, continue to be payable despite this periodical stoppage of business. We will assume that his purchases and other variable charges amount to 50 per cent of his turnover, and having stated this percentage, we can eliminate his turnover from our diagram. This will make for simplicity and economize our space, for we can content ourselves with studying the level of the remaining half of his turnover—the part which is available for the payment of standing charges, any surplus being net profit.

We will regard the standing charges of the business as amounting to £1,200 per annum, for this gives us a round £100 per month, and, allotting a value of £100 to each square in our diagram (Fig. 2), enables us to represent these charges, accruing monthly, by the straight line *A—B*. The fluctuating amount of profits (net profit and standing charges) earned month by month reaches its highest point during the months of July and August, and the area enclosed by the profits line, *above* the level of the standing charges, will, of course, represent net profit if we regard the operations of each month as separate units. During the first three months of the year, no business is being transacted, but standing charges are incurred at the rate of £100 per month. By the end of March, therefore,

a net loss of £300 has been sustained. The month of April earns sufficient to pay its own standing charges, but no more. May shows a surplus of £100 and June a surplus of £200. At the end of June, therefore, sufficient has been earned to date to meet the losses of the first three months. As is to be expected, July and August prove the most profitable months, and between them yield £600 net profit. September results in a further £200 surplus, but this is offset by losses of the same amount incurred during November

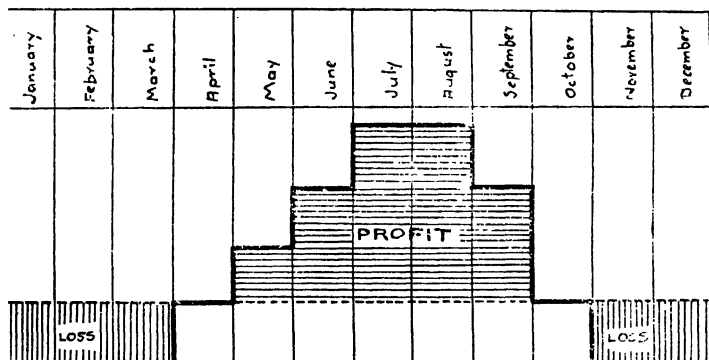
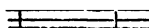


FIG. 2

and December. The net result at the end of the year is that the business has yielded a surplus of £600, for £1,100 profit has been earned during the summer months, but from this must be deducted the losses during the winter months, namely, £500. Month by month, there is no doubt that the trading during July and August was the most profitable, but that is merely because the standing charges have been arbitrarily and artificially allocated in equal amounts monthly throughout the year. In actual fact, the business of one month, £ for £, has the same earning power as the business of another. Turn again to the diagram. Assume that the trading for the month of October was interrupted. That means a loss of £200 of turnover, for we are regarding the business as having a 50 per cent earning capacity. The loss of October's trade would mean that the standing charges of that month, instead of having been earned, as shown in the diagram, would have been converted into a net loss, as they were in each of the winter months,

reducing the year's net profit from £600 to £500. In the same way, had the turnover of August been reduced by £200 from any cause, then the total profit of the summer months would have been £1,000 only, instead of £1,100, and after provision had been made for the losses of the winter months, totalling £500, the year's net profit would again have been £500 instead of £600 as shown. The actual



VARIABLE

FIG. 3

value, then, of £200 of business is the same, in whatever month it is transacted, from which we see that the loss of business during one season will have the same ultimate effect as the loss of a similar amount of business at any other time of the year.

If we view the earning capacity of a seasonal business in the light of a series of separate periods, *each bearing an equal share of the standing charges*, we obtain only a distorted idea of the true state of things. Either we should regard the operations of the whole year as one composite affair, seeing that each season's results bears a definite relation to the ultimate results of the whole, or else we must re-allocate the standing charges in accordance with the amount of business done. To continue our series of diagrams, we

can either regard the year's business in one total, setting the total expenses against the total receipts, as in Fig. 3, or else debit each month's trading with its proportionate part of the year's standing charges, as has been done in Fig. 4.

Fig. 3 gives us a bird's-eye survey of the year's operations. We see that, so long as the annual turnover is maintained, one-sixth

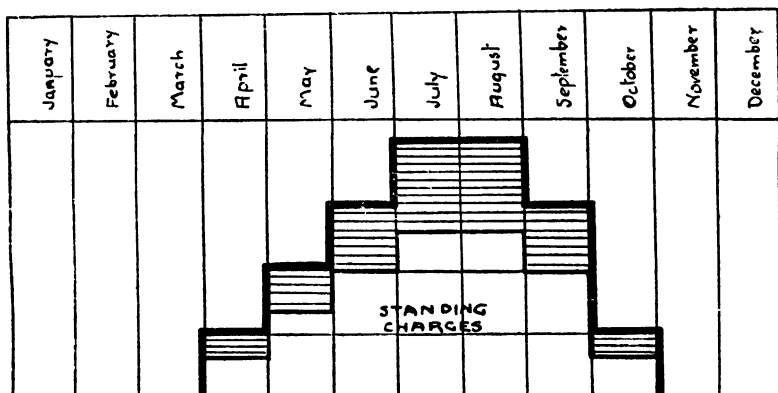


FIG. 4

of it is converted into net profit, whilst the standing charges absorb a third of it. Fig. 4 carries that conclusion a little farther. It analyses the results of each month's trading after a true allocation of the standing charges in proportion to the amount of business done; in other words, to the extent that those charges have been earned by the trading of each individual month. This enables us to see that the attainment of a normal net profit is entirely dependent upon the transaction of a normal volume of business, and that a loss of turnover will result in an ascertainable trading loss, in that each £ of turnover, during whatever season it be transacted, definitely contributes its quota towards the standing charges and net profit of the business.

CHAPTER III

System of loss measurement embodied in the policies—Determination of the amount of business lost—The standard—The percentage payable—Adjustment of shortage.

IN connection with insurances which relate to material property, whether the peril insured against be fire, burglary or other contingency, it is usual for the contractual part of the policy to be expressed in some such words as—

. . . the Company will pay or make good to the Insured the value of the property so destroyed or the amount of such damage thereto.

The policies contain in themselves no definite indication as to the manner in which the extent of the loss will be established, and the remarkably small number of disputes arising thereunder which find their way to our Courts of Law bears striking testimony to the efficiency of claim assessment methods adopted in this country. The policies merely state that an indemnity will be afforded. The problems likely to arise in carrying into effect the purpose of the insurance are wisely deferred until the loss occurs. All the circumstances affecting the position can then be taken into account in arriving at the amount the Insured is entitled to receive as indemnity for his loss. The virtue of the contract lies largely in its freedom from restriction. Any attempt to predetermine the steps that should be taken to gauge the extent of the loss would inevitably tend to obscure rather than elucidate the position when the policy is put into operation. Two centuries of insurance practice have resulted in the establishment of a recognized code of loss assessment on which both Insured and Insurer may confidently rely.

In connection with losses under Profits policies, however, we are faced with a very different position. It is only within recent years that the business has been transacted to any general extent, and there exists no hard and fast method which can equitably be applied to the measurement of all such losses, irrespective of the trade carried on and the characteristics of the individual business concerned. We must remember that Profits Insurance indemnifies in respect of something intangible; something which has never existed; something in respect of which concrete evidence cannot be obtained

in the sense that it can in the case of buildings, machinery and stock. In connection with ordinary fire insurance it becomes necessary to establish the state of affairs which existed *at the time of the fire*. Here we have to establish those which *would have existed* after the date of the fire, had it not occurred. Opinions may legitimately differ as to what would have happened if a certain contingency had not taken place.

System of Loss Measurement Embodied in the Policies.

If, when a loss occurs, serious clash of opinion is to be avoided, it is necessary that a definite understanding should exist between the Insured and his insurer as to the manner in which the loss of earning power due to the fire is to be assessed. Machinery must be set up, before the fire occurs, to establish as accurately as may be the trading loss so caused.

For this reason Profits policies, alone among all policies of indemnity, invariably embody a definite scheme for the measurement of losses occurring thereunder. It is to be expected, therefore, that the general appearance and form of a Profits policy must differ substantially from those which relate to the Insured's interest in material property. It is occasionally necessary to evolve and embody in a Profits policy special systems of loss measurement of a complicated character to meet the particular requirements of an individual business, but speaking generally, the profits policy of to-day is a triumph of clarity. When we consider the task of those who were responsible for framing and developing the policy, we must concede that theirs was no small problem. They were faced with the duty of laying down a system, to be put into operation on the happening of a contingency which had not arisen, for the measurement of something which had never materialized. It is not to be wondered at if, to our eyes, some of the earlier policies seem to have erred on the side of ultra-caution.

We have already viewed the principles on which Profits Insurance is based, and have noted the unaltering ratio of earning power to turnover. We can now consider what further steps are necessary to apply those principles to the measurement of trading losses.

Now, it will be apparent that, to determine the amount of the loss

incurred by the interruption of business through fire, two definite steps must be taken. We must first of all establish the extent to which business has been lost as the result of the interference with trade, and when that has been done we must ascertain to what extent such loss of business represents loss to the Insured.

Determination of Amount of Business Lost.

We will first consider the manner in which we can arrive at the volume of business that is lost as the result of fire. Here, again, the task resolves itself into two definite stages. We must remember that we are dealing with the curtailment of *business activity* after the fire and that no recognized unit has been standardized for its measurement. We must, then, adopt a unit of our own, for without a unit no measurement is possible. We must clearly indicate what is to be regarded as the index of business activity, for in the absence of a standard unit, it can quite legitimately be expressed in widely differing terms. The same position may arise in, say, the case of a manufacturer who compares the work of his motor fleet in one period as against another. He can speak of the relative amount of work done in both periods in terms of "miles covered," "petrol consumed," or "loads carried." Each comparison might give substantially the same result, because each index bears a definite relation to the other, but it is doubtful if the results would exactly coincide. If he particularly desired statistics to prove a certain point of view, he could select figures expressed in the unit which would most nearly give him the result he desired. It is essential, then, in connection with the measurement of profits losses that we should lay down the unit of measurement which shall be utilized for gauging the extent to which business has been affected as the result of fire.

Now, in connection with the majority of business undertakings, trade activity is conveniently and accurately measured in terms of "money received"; in other words, "cash takings" or "turnover." The volume of business transacted is usually so spoken of, and in the simple examples that have been utilized in previous chapters we have adopted turnover as being the index most suitable for our purpose. We have seen that the maintenance of net profit is dependent upon the maintenance of turnover. It is the turnover of a business which its principal watches so keenly

in order to satisfy himself that the undertaking is making healthy progress. When business expands, turnover increases. When it diminishes, turnover shrinks, and so we have, in the turnover of a business, an accurate and easily ascertainable index of its activity.

The Standard.

At a later stage we will consider other recognized units for the measurement of the volume of business done. For the present, we will confine ourselves to turnover as the means by which business activity is registered. But it is necessary to do more than predetermine the unit by which we are to gauge the amount of work done. We must also set up a standard, expressed in such units, which shall represent the normal activity of the business during any given period—a standard with which the amount of work done after the fire can be compared in order to ascertain the shortage.

Let us revert to the case of our manufacturer owning the fleet of motor-cars. He may make up his mind that the most equitable index for his purpose is "loads carried." If he desires to judge the work of the current month, he must set up a standard representative of the normal number of loads carried per month. Perhaps the total of the previous month will afford an equitable basis, or if the monthly total is liable to fluctuate, he will, perhaps, take the carryings of the previous three, six or twelve months, and strike an average. Should the business be at all seasonal in character, it will be necessary for him to turn up the records relative to the corresponding month in the previous year, or even to take the average of the corresponding months in, say, the past two or three years. If his business is progressive, as well as seasonal, he must take the totals of the same month in the previous year and add something to it which will represent the additional number of loads brought about by the natural growth of the business and the increased number of vehicles during the past year. His own knowledge of the circumstances affecting his own business will enable him to determine what might properly be regarded as an appropriate total to represent a normal standard of work. If, against this standard, he compared the number of loads actually carried, making due allowance for any special circumstances which affected the work of the current month or that of the period which supplied his

standard (such as the temporary breakdown of vehicles, weather conditions and the like), he would then be in a position to judge whether the carryings of the month under review were below, or in excess of, the total he is entitled to expect.

The same principle can be applied to the figures representing the volume of business transacted before and after a fire. We first determine the most convenient unit for measuring the activity of a business, whether it be the £ sterling of turnover or other term, and then set up a standard to represent the normal volume of business during any given period of the year.

If a business is well established and, by reason of its character, not liable to very material fluctuations from year to year, the activity of the corresponding period in the previous year will give us a fairly reliable guide as to what might reasonably have been anticipated during the same period had the business not been interrupted by fire. The volume of business actually transacted during the affected period may be compared with that of the corresponding period in the preceding year, and whether that period represents the busiest or the slackest part of the business year, the shortage due to the fire will thus be evidenced, due allowance being made, of course, for any untoward event apart from the fire which obviously affected the trading of either or both of the periods in question.

If, however, the business is such that it does, in fact, vary considerably from year to year; if the results of the corresponding period in the previous year cannot be relied upon to give us an appropriate standard, it may be necessary and advisable to seek guidance from the average results of the same period during the past two or three years, or even longer.

Neither of these standards, however, is applicable to the healthy business which is consistently progressive. The results of the corresponding period in the previous year would, in the natural order of things, have been surpassed had the business not been interfered with by fire. The past history of the concern is one of uninterrupted progress. If its results were plotted diagrammatically, we should see that the line indicative of its past turnover maintained an upward tendency. It is reasonable to assume that the figures of the previous year would ordinarily have been exceeded

had the fire not occurred. Last year's results will be appreciably short of what might reasonably have been expected this year—the average of the past three years will be even more wide of the mark, and so it is necessary, in such a case, to set up an ever-increasing standard of activity ; one which can be relied upon to take into account the natural expansion of the business which, as indicated by its history, would have occurred in normal circumstances. To do this we must first make provision for ascertaining the rate at which the business *was* expanding before the fire occurred. We can take its activity for, say, six months anterior to the fire and compare it with that of the corresponding period in the previous year. If we find that an expansion of, say, 10 per cent is thus shown, we can reasonably assume 10 per cent to be the rate at which the business was increasing at the time of the fire, and if we apply that ratio of increase to the business transacted in the period in the previous year corresponding with the period of interruption, we arrive at a figure which can well be regarded as the amount of business which might have been anticipated had the fire not occurred.

The standard we decide to adopt, after a full consideration of the circumstances affecting the business concerned, will afford us a datum line against which to compare the volume of business actually transacted, despite the fire, and so establish the shortage in business due to the fire.

It will be seen that no hard and fast rule is laid down as to the manner in which the “ normal ” or standard turnover shall be arrived at. Obviously it cannot be. The system applicable with fairness to one business would give quite fantastic results if applied to another, but, generally speaking, no difficulty is found in predetermining an equitable standard, expressed in convenient units, freely acceptable to reasonable men as forming a basis for the determination of the amount of business lost as the result of fire. It is a matter for agreement between Insured and his insurer at the time the contract is effected, the nature and history of the business indicating the standard most applicable.

The Percentage Payable.

Having laid down a system for the measurement of the amount of business lost, it remains for us to calculate what that lost business

represents in actual loss to the Insured, and on this point we naturally look for guidance to the records of the last completed trading period. From the accounts of the business relating to the last financial year we are able to judge its normal earning capacity. We can learn how much each £ of turnover is capable of yielding in the form of net profit and standing charges. Where the dividing line is drawn between these two items in normal times is a domestic matter which concerns only the Insured. It is a problem that is always with him, for the lower he can keep his standing charges, the greater will be his residual net profit. But in the event of fire, the point of common interest to the Insured and the Insurer is the *earning power* of the business—the proportion which the total of the net profit and standing charges bears to the normal turnover.

We have briefly glanced at the manner in which we can ascertain both the shortage in turnover due to the fire, and the percentage of that shortage which represents loss to the Insured. In order, therefore, to arrive at the amount of the trading loss incurred, it is necessary to apply the one to the other. The Insurance Company becomes, in effect, the customer of the Insured to the full extent of the amount of business lost through fire, but as no goods are actually delivered, the Company deducts the net cost of purchase or manufacture, or at least, all those charges which were not incurred by reason of the fact that no purchase or manufacture was undertaken. Provided the insurance is for an adequate amount, the Insured receives the balance, which is, of course, the amount which such a transaction would normally have contributed towards the payment of his standing charges and his own net profit.

Adjustment of Shortage.

It will be apparent, though, that the rigid application of any pre-agreed scheme may well have the effect of defeating its own end if it lacks a certain measure of elasticity when the time comes to put that scheme into operation. The declared purpose of our pre-arranged scheme of measurement is to determine the loss of net profit and standing charges brought about by the interruption of business through fire. To achieve that purpose, we set up our standard of trade activity and undertake to measure depleted business against it in the reasonable belief that it will, in ordinary

circumstances, give us an equitable result. But in this uncertain world, we must provide for the unforeseen—or at least, leave ourselves free to deal with the unforeseen as it arises. If the principle of indemnity is to be maintained, we must not be blind to any abnormality of trade, whether it occurs after the fire or during the period which provides us with our standard of trade activity. When all is said and done, the whole basis of our scheme consists of a comparison of the abnormal with the normal. And the only abnormality with which we are concerned is that brought about by the fire. It may be that the period which we select as representative of the normal is itself abnormal from circumstances unconnected with the fire. Similarly, the depletion of turnover after the fire may have been aggravated or partially hidden by factors quite independent of the fire. Any untoward event, such as a breakdown of machinery, a flooding of works, or a strike of employees, whether it occurs before or after the fire, may have the effect of upsetting our calculations. We must obviously make due allowance for such occurrences in arriving at the amount of business lost in consequence of fire; we must leave ourselves free to deal with these things in the light of equity if, through any extraordinary circumstance, our accepted scheme of measurement yields a figure demonstrably above or below the amount that the business would have earned if no fire had occurred.

Additional Expenses.

We have already noted that the Insured will not be fully indemnified by the recovery of the sum which would have been earned in the ordinary way by the volume of business lost through fire, if in respect of the business he has managed to maintain, despite the fire, he has had to incur extraordinary costs. We have cited the example of rent of temporary premises as typical of the class of expenditure to which we refer, and it will be apparent that the business carried on from such premises will not show its normal ratio of profit because it has been saddled with an additional charge which would not, in the ordinary way, be incurred. The effect of this further source of loss would not, of course, be disclosed by the application of the system of measurement we have been considering. Fortunately, however, items of additional expenditure

incurred after a fire can usually be recognized as such without any difficulty. It is no longer a matter of estimating what *would have occurred*. The amount of additional expenditure incurred to maintain business after a fire is determined by facts. The total is readily ascertainable, and relieved of it, the business maintained would yield its normal surplus, above the costs of production, for the payment of net profit and standing charges. Subject to an adequate insurance, it is only fair that the Insured should be able to recover such expenditure in addition to the amount of trading loss arrived at in the manner already indicated, but, needless to say, some safeguarding provision must obviously be imposed in regard thereto. To be recoverable, the expenditure must have been necessarily incurred in consequence of the fire, and must be directed solely to the maintenance of business. The Insurance Company cannot countenance a programme of riotous expenditure at its expense, and the limit it places is the *amount earned* by the business so maintained. This is clearly reasonable. To incur expense beyond that limit is to "throw good money after bad."

The foregoing is a brief but general summary of the system adopted for the measurement of loss of profits following fire. Having thus sketched out the method, we can proceed to consider how it can be translated into practice and embodied in the policies.

CHAPTER IV

Policy based on twelve months preceding the fire—The business—Contingencies insured against—Period of Indemnity—Profits—Turnover—Clause (a)—Clause (b)—Total liability—Fire—Example of Loss settlement.

To facilitate our examination of the manner in which a profits policy gives effect to the system of measurement outlined in the previous chapter, we will consider the construction of a typical policy of simple type, namely, one which, utilizing turnover as the index by which activity is to be gauged, adopts the results of the previous year as the basis upon which shortage is to be measured. Such a policy may be regarded as suitable for the requirements of an established business, not subject to appreciable fluctuations year by year, and in respect of which no material expansion over the previous year may reasonably be anticipated. It is immaterial whether the business be at all seasonal in character, for we may assume that, in the ordinary course of events, the different seasons will fall at approximately the same periods each year and, consequently, a comparison of one season's trading with that of the corresponding period will give us a reasonably satisfactory basis upon which to assess shortage.

The wording of the policy we will examine is given in Appendix III. It will be convenient to glance at it at this stage, after which its various provisions can be examined in detail and commented upon.

It is to be observed that no standard policy has been adopted by the offices generally in connection with Profits Insurance. Indeed, it is so frequently necessary to vary the usual policy provisions to meet some special case that standardization would be extremely difficult. Although the policies issued by the different offices are, in form and general construction, often very dissimilar, their principles are the same. Their differences are merely those of expression, but the form of policy we are considering may be regarded as typical.

The Business.

After reciting the name of the Insured, the policy records that he is "carrying on the business of . . ." say, a grocer, and we

must keep well in mind that by so doing there has been noted the subject-matter of the insurance, namely, the *business* of the Insured. It is that business, and no other, in respect of which we set out to provide an indemnity. Then follows the location of the premises from which the business is conducted and the policy comes into operation only following fire damage occurring at the premises named. Here it may be noted that the "premises" embodied in the policy need not necessarily be limited to those occupied by the Insured for the purpose of his own particular business. It may be that his business would be materially affected by the occurrence of a fire elsewhere, and if this is apprehended such other premises may be included within the scope of the policy. If, for instance, the Insured relies upon another firm for the supply of his raw material, he may wish to protect himself against a stoppage of his own business arising from a fire at that firm's premises. If so, those premises would be included, with his own, in the preamble of the policy, and the policy would then operate following a fire either at his own premises or at those of his suppliers. Similarly, he may depend upon a certain customer for the major part of his sales. Those purchases would probably cease if the customer's premises were destroyed, and such other premises might, therefore, be included in the policy. In fact, there is no reason why the Insured should not include any named premises, whether in his own occupation or not, upon which he relies for purchases, sales, or services. If the continuity of his own business is dependent upon the existence intact of property anywhere, a profits policy can be made to extend thereto by the inclusion, among the "premises," of the addresses at which such property is situated.

Having, then, set out the nature of the business—the subject-matter of the insurance—and the location of the property necessary for carrying it on, the policy further states that if, during the currency of the insurance

(i) the premises or property therein of the Insured shall be destroyed or damaged by fire, and

(ii) the business shall be thereby interrupted or interfered with

the Company will indemnify the Insured in respect of certain losses as set out in the policy.

Contingencies Insured Against.

Two distinct eventualities must come about before the Insured can claim under the policy. In the first place, a fire must occur at one of the premises enumerated in the policy, and the property therein of the Insured must be destroyed or damaged thereby. If, of course, the Insured has included premises other than his own—say those of his wholesaler—some amendment of the usual policy wording would be necessary as regards the words “of the Insured” in relation to the property destroyed or damaged by fire, seeing that such words would in that case obviously be inapplicable. The intention of the policy is to make it quite clear that the losses it covers are those directly caused by fire at the “premises.” It does not apply if business falls off as the result of fire elsewhere. For instance, the occurrence of a disastrous fire at a cinema, resulting, perhaps, in several fatalities, would, for a time, affect the takings of other similar houses of amusement in the neighbourhood. The tragedy would create a sense of public alarm that would certainly be reflected in the box-office takings of other cinemas for some while. Similarly, a fire at other premises in the same street might render necessary the closing of the thoroughfare until debris had been cleared away, and this might result in a falling off of trade at every house of business in the street.

It is essential, too, that the business described in the policy be interrupted or interfered with as the direct result of the fire. The insurance is in respect of loss of profits *through fire*, and the mere occurrence of the fire does not bring the policy into operation unless it causes loss of trading profits. In a previous chapter we have cited an example of fire damage which would probably have no effect whatever upon the trading results of the business concerned.

Period of Indemnity.

Before we examine the contractual clauses which follow the preamble of the policy we must consider a term, peculiar to Profits Insurance, which occurs therein. We refer to the “Period of Indemnity,” which is defined as—

The period after any fire during which the business is interrupted or interfered with, but not exceeding . . . consecutive calendar months from the date of such fire.

It will be seen that the period of indemnity bears no relation to the term of the insurance. Profits policies are almost invariably annual contracts, but the period of indemnity can be of any duration up to three years, or even longer. The period of indemnity may, indeed, embrace a period during which the insurance is not in force, for if an insurance were allowed to expire after the occurrence of a fire, the period of indemnity thereunder would run its course quite irrespective of the expiry date of the insurance.

The selection of the maximum period of indemnity for embodiment in the policy is a matter for decision by the Insured at the time the insurance is effected, and in deciding the point, he should of course choose a period which, from his own intimate knowledge of the business, would be likely to represent the longest period during which his business would be affected following a serious fire. He can estimate the time necessary to replace the building and its contents and will be in a position to judge how long thereafter the business would, from its nature, take to recover fully from the effects of the fire. The premium for the insurance will, of course, be affected by the length of the period so selected, for it will be included in the policy as the limit of time during which the Insurer is liable for trading losses after a fire. It is very important, therefore, that this maximum period should be of sufficient duration to cover the whole period of actual loss, for an Insured will be insufficiently protected if the period of indemnity is inadequate just as he will be underinsured if the sum insured is insufficient.

It should be noted that, from the point of view of the operation of the policy, the period of indemnity is the period, within the stated maximum, *during which the business is affected by the fire*. There is no necessity—in fact it is inadvisable—to allow the whole of the stated maximum period to elapse before the loss is calculated. In practice, the period of indemnity may be of any length from one day—even a part of a day—to the whole of the maximum period stated in the policy, which is usually three, six, nine, or twelve months.

It should be further observed that the maximum period is stated as being so many *consecutive* calendar months. Obviously, it is not the intention that an Insured should be put in the position

of being able to say after a fire that the operation of the policy should be suspended during certain months when only negligible losses are being sustained, the maximum period being correspondingly extended to embrace later periods when more serious losses are perhaps being incurred.

We can now revert to the contractual clauses of the policy, which are prefaced with the words—

The Company will indemnify the Insured and make payments monthly at the option of the Insured in respect of—

Here it is clearly stated that the intention of the policy is to indemnify, and to indemnify only. A profits policy is *not* a valued contract undertaking to make the post-fire profits up to those of a stated period before the fire without proof of loss. It is an instrument of *indemnity*, the purpose of which is to make good the trading losses actually sustained as the result of fire. This point is emphasized throughout the whole policy.

The second part of the sentence refers to the practice which is occasionally adopted for the convenience of the Insured of making periodical payments on account of the loss. It is, of course, in the interests of the Insurer that the Insured should not be hampered in his operations by lack of funds, and if, during the course of a long period of interruption, payments at intervals on account of loss to date would be of assistance to the Insured, it is clearly advisable that they should be made. In practice, however, such payments on account are not invariably made, the losses frequently being settled by one payment after the business has regained its normal activity, or after the expiry of the maximum period of indemnity as stated in the policy.

As we have seen, the losses incurred by the Insured fall under two headings—

- (a) Loss of net profit and standing charges.
- (b) Increase in cost of working,

and a separate clause in the policy is devoted to loss in each category. Both clauses are somewhat lengthy and inclined perhaps to unwieldiness, but the method now adopted of defining certain terms and grouping the definitions has done much to simplify the whole contract.

Profits.

The first contractual clause deals only with the loss of net profit and standing charges. For the total of these two items, there has been adopted the term "profits." This constitutes the first of our definitions, and embraces the second as well. It reads—

Profits. The net profit of the business added to the specified standing charges.

In the next definition, the specified standing charges are enumerated by description but not in amount. The purpose of specifying them is to indicate clearly the items which the Insured selects, when effecting the insurance, as being charges which will continue to be payable in full after a fire, or which cannot be reduced proportionately with any falling off of business. His premium, of course, is calculated upon the total he gives as representing the aggregate of his net profit and the standing charges enumerated.

The word "profits," then, means net profit and specified standing charges. If these latter have been properly selected and the sum insured appropriately calculated, the profits insured will constitute that part of the Insured's turnover which, in the event of a reduction of business, is likely to represent actual loss to him, for there will have been excluded from the insurance only that part of his turnover which is consumed by those charges that are variable proportionately in amount.

We can diagrammatically illustrate the operation of a profits policy with regard to loss of net profit and standing charges by depicting a cessation of turnover and its gradual return to normal. In Fig. 5 this has been done by the continuous line commencing at *A* and ending at *D*.

The fire occurs at *B* and totally stops the turnover for a period, after which it gradually regains normal at the point *C*. The period of indemnity is accordingly represented by the space between *B* and *C*. The normal earning capacity of the business—the proportion it yields for net profit and standing charges—is indicated by the level *E—F*, and we notice that, with the partial resumption of business, its earning power is regained proportionately until at *C* it reaches the level from which it dropped originally. The shaded area, therefore, represents the Insured's loss of net profit and standing charges.

For the purpose of our diagram we have assumed in Fig. 5 that the turnover remains steady throughout the year under normal conditions. In order to illustrate the position with regard to a seasonal business, we will vary the diagram and show, in Fig. 6,

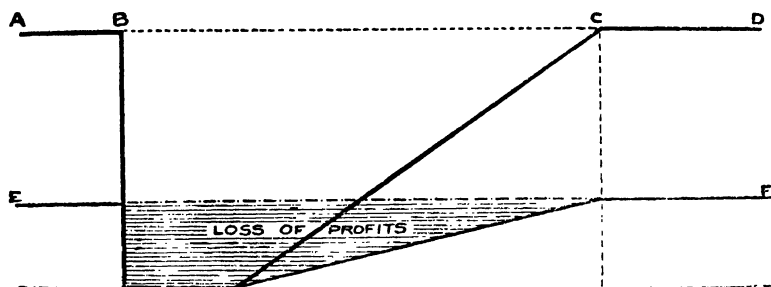


FIG. 5

the effect of an interruption of business during the busy season of the year. The same lettering will apply, but in order more closely to approximate what is likely to occur in practice, we will no longer

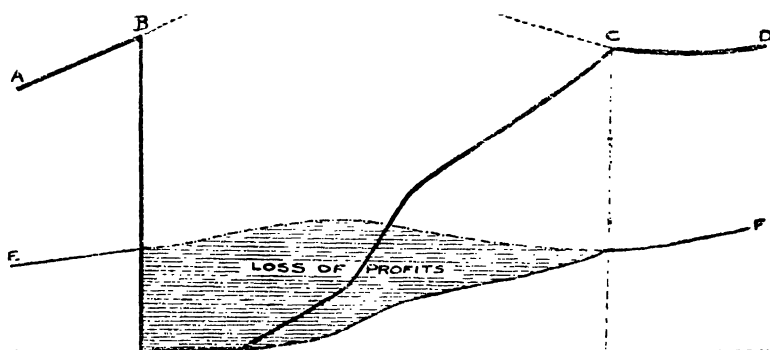


FIG. 6

assume that the turnover is gradually and evenly regained after the period of total stoppage. It will be seen that the earning power of the business actually transacted, as represented by the unshaded portion of the area below the "earnings" line E—F is governed entirely by the amount of turnover transacted, and the shaded portion again depicts the actual loss sustained by the loss of turnover.

Turnover.

As our first contractual clause deals entirely with the effects of a loss of turnover, it is necessary that we should state explicitly in the policy exactly what we mean by the use of the term. It is obviously desirable that there should exist no misunderstanding as to the sense in which the word is employed wherever it appears in the contract, seeing that it is to be the index for the measurement of the Insured's loss. It is to be utilized to gauge the extent of business activity, both before and after the fire, and so we must make it clear that we mean "revenue earned" rather than revenue actually received. The act of selling goods registers activity more reliably than does the receipt of cash from customers. For our purpose, it is immaterial when a customer's account is settled; we are concerned more with the actual sale or service which created the outstanding balance, for it is then that the revenue was earned. We accordingly frame our definition of turnover to make this clear. It reads—

Turnover. The money paid or payable to the Insured for goods sold and delivered *from the premises and from other premises occupied by Insured for the purpose of the business during the period of indemnity* and charges for work done.

The words in italics have only lately found their way generally into Profits policies following a legal decision (*City Tailors v. Evans*) of recent years. One of the points on which the case turned arose from the fact that the Insured took temporary premises after the fire and they successfully contended that the turnover so maintained could not be brought into account in computing their loss. The policy was not in all respects similar to the one we are now considering. In the event of partial loss, it undertook to pay a proportionate part of the insured amount per day based on the diminution of turnover at the Insured's premises. There was no provision under which the Insured could claim for the Increase in Cost, due to the taking of temporary premises, and so the Underwriters' position was somewhat weaker, perhaps, than would be the case under a policy which, by its provision for Increase in Cost of Working, clearly contemplated the taking of temporary premises and the adoption of other similar expedients for the maintenance of business during the period of indemnity. However, the case directed

attention to the necessity for tightening up the definition of turnover then in general use, and the addition of the italicized words has been the result.

The general intention of the definition is to limit the term "turnover" to those items of revenue which reach the Insured in the ordinary course of his trading in connection with the business insured. Receipts which do not accrue from current trading (as, for example, interest on investments and the like), serve no useful purpose as an index of activity, and, moreover, are unlikely to be affected by fire. They are, therefore, excluded from our calculations in arriving at the loss of business brought about by fire. The definition limits "turnover" to "the money paid or payable for goods sold and delivered and charges for work done."

It is sometimes considered advisable to vary the definition—always with the same purpose in view—to make it more clearly applicable to the usual trade receipts of certain businesses. For instance, the turnover of a theatre proprietor might read—

The money paid or payable to the Insured for entertainment, refreshment and advertisements,

whilst other particular trades or businesses may need appropriate adaptations of the usual definition to embrace those receipts which can properly be regarded as indicative of business activity.

Having glanced at the definitions necessary for an appreciation of the terms used in the two contractual clauses, we can now examine in detail the clauses themselves, but it will be convenient to break off here and there during their recital, and interpolate such comments as may seem desirable.

Clause (a).

The policy undertakes, as we have seen, to "indemnify the Insured in respect of"

(a) Loss of profits sustained during the period of indemnity . . .

The word "sustained" again emphasizes the principle of indemnity. The loss must be actually sustained before it is recoverable. It must, moreover, be sustained during the period of indemnity. Any losses which occur after the expiry of the maximum

period stated in the definition of "period of indemnity" must be borne by the Insured himself

. . . in consequence of such interruption or interference.

"Such interruption" means, of course, the interruption brought about by the contingencies mentioned in the preamble of the policy, namely, the occurrence of a fire at the "premises" and the destruction of or damage to the Insured's property therein. The cover under the policy applies only to losses due to such interruption or interference. If, after a fire, other factors (such as strikes, weather conditions and the like) obviously contributed to the loss of profits sustained, the policy is concerned only with that part of the loss directly attributable to the interruption or interference caused by fire. That is the loss insured against; the premium paid to the Company secures indemnity in respect only of loss of profits caused by *fire*.

. . . but not exceeding the ascertained percentage of the sum by which the turnover of such period shall, in consequence of such interruption or interference, fall short of the turnover of the corresponding period in the twelve months immediately preceding the fire . . .

Here we set up our standard of normal trading activity against which to measure shortage, viz.: the turnover of the period in the preceding twelve months corresponding with the period of indemnity, and by means of a definition of the term "Ascertained Percentage" we introduce a means of determining what proportion of the lost turnover represents actual loss to the Insured. It reads—

Ascertained Percentage. The Percentage of the sum insured to the turnover for the twelve months immediately preceding the fire but not exceeding the percentage of profits in the last financial year preceding the fire to the turnover for that period.

This definition plays a very important part in the general operation of the policy. Not only does it establish the extent of the Insured's loss, in that it applies to the shortage of turnover the proved earning capacity of the business under normal conditions, but it also introduces the principle of average. The definition is not a long one, but its importance will be realized when it is seen that it thus embodies protection against both over-insurance *and* under-insurance. At a later stage we shall see that, for the form of policy we are considering, the Insured should effect an insurance for the total of his net profit and specified standing charges for the last financial year. If he does so, the first part of the definition will give a result

identical with that of the second, provided there has been no expansion or decrease of business since the close of the last financial year. Assume an annual turnover of £10,000 and profits of £2,000. If the sum insured has correctly been effected for the latter figure, the percentage of the sum insured to the turnover for the twelve months preceding the fire will be 20 per cent. So, too, will the percentage of profits to turnover in the last financial year. Only a marked expansion or diminution of business since the end of the last financial year would produce any appreciable difference between these two percentages, and it is to be borne in mind that we are considering the case of an established business in respect of which no notable variation in the volume of business transacted is to be anticipated. A correct sum insured, then, in these circumstances, produces the same percentage, whichever part of the definition of "Ascertained Percentage" is applied. Under-insurance will yield a percentage smaller than the Insured's actual percentage of profits to turnover, and so result in a sharing of the loss between the Insured and the Insurer proportionate to the extent of the insurance. If, to revert to the example just given, the insurance had been effected for £1,000 instead of for £2,000, the first part of the definition would yield 10 per cent only, whereas we have seen that the 20 per cent represents the real measure of loss. The sum insured being only half of the full insurable amount, only one-half of the appropriate full premium would have been paid for the insurance, and, therefore, by the application of the principle of average, only one-half of the loss is recoverable under the policy.

It will be seen that the proportion of each loss which the Insured can obtain under a profits policy is automatically regulated by the extent of the sum insured, up to the point of full insurance. Thereafter, the second part of the definition operates for the protection of the Insurer by limiting the percentage recoverable to the actual earning capacity of the business as shown by the latest accounts. Had the insurance, in the above instance, been taken out for £3,000, the percentage of the sum insured to the turnover of the twelve months before the fire would give us a figure of 30 per cent, but the limit of 20 per cent imposed by the second part of the definition would prevent the Insured from gaining as the result of his over-insurance.

It will have been noticed that reference is made throughout the policy to two different periods of twelve months, and the significance of this should be clearly appreciated. In setting up our standard turnover, against which to measure shortage, and in applying the first part of the definition of "Ascertained Percentage," we refer to the "turnover of the *twelve months* immediately preceding the fire." In the second part of the same definition, wherein we limit the percentage recoverable to the actual percentage of profits yielded by the business under normal conditions, we refer to the percentage of profits to turnover "in the last *financial year*." Now the actual periods of time covered by these two references may be almost entirely different. If a fire should occur, say, eleven months after the close of a financial year, only one month's trading would be common to both periods. On the other hand, if the fire should occur on the last day of the financial year, both periods would exactly coincide. But there is a reason for this difference in phraseology. Remember that we are utilizing the past experience of the business to enable us to determine its probable yield had no fire occurred. In ordinary circumstances, then, the more recent the experience the more reliable it is likely to be for our purpose. If we seek guidance from the results of a period more remote than necessary from the period of indemnity, there is always the possibility that those results were powerfully influenced by certain factors and circumstances which no longer exist, and the farther we delve into the past, the greater does that probability become. Bearing in mind that our purpose is but to indemnify in respect of losses caused through fire, it follows that our endeavours must be directed towards establishing, from the actual results of the business in the past, the amount of loss sustained during the period of indemnity. We accordingly turn to the results of the most recent period that presents those features which might be expected to characterize the period under review. So far as the *volume of business* is concerned, the corresponding period in the preceding twelve months obviously affords us the latest and most up-to-date experience. In arriving at the shortage in turnover, therefore, we adopt as our standard the amount of business actually transacted during that period. When we seek information as to the normal earning capacity of the business—the ratio of profits to turnover that it

is capable of yielding—we apply the same principle, namely, the utilization of the results of the latest period available. We cannot, however, obtain our data from the same period that furnishes us with our turnover figures, for “profits” means *net profit* and specified standing charges, and to ascertain the net profit of a business during any given period, it is necessary to take into account the value of the stock at the beginning and end of that period. Stocktaking is a tedious affair, usually undertaken but once every twelve months at the close of a firm’s financial year. The accounts are then made up, and the amount of the net profit for the period is ascertained. When we calculate the percentage of profits to turnover, therefore, we must take the results of a complete accountancy period. We must compare the profits with the turnover of that period to establish the earning power of the business. The results of the last completed financial year accordingly constitute the latest figures—and as such probably the most reliable—upon which to base our calculations. If this is clearly understood there should be no confusion as to the references in the policy to the two differing periods of twelve months. Wherever the aim is to establish the *volume of business done*, we can, without difficulty, take the turnover figures for the *twelve months preceding the fire*, or for any broken period within that twelve months, for in most businesses the turnover figures are recorded daily. Where, however, we look for the latest information as to the amount of *profits* that the business has yielded, then we must turn to the figures of the last completed *financial year*.

The first main clause of the policy terminates with a proviso introduced in emphasis of the fact that the contract is one of indemnity only. It reads—

. . . provided that if the amount of the specified standing charges shall be reduced, the amount payable shall be reduced accordingly.

The policy has already stated in unequivocal terms that the intention of the insurance is to indemnify in respect of loss of profits *sustained*. “Profits” includes the amount of the specified standing charges, and if any of those charges ceases to become payable after a fire, then, as a standing charge, it ceases to exist and no loss is incurred in respect of it. If, in addition to his normal net profit, the Insured recovered under his policy the amount insured in

respect of that charge, and did not pay it away, he would be the gainer to that extent as the result of the fire, and it would clearly be at variance with the spirit of indemnity to countenance such a position. The proviso we are considering makes it clear that, to be recoverable under the policy, a standing charge must actually be payable after a fire.

As an illustration of the position that the proviso is designed to meet, we may consider a cessation or reduction of rates during the period of indemnity. After a destructive fire it may be that the Local Authority will, on application, forgo its claim in respect of the fire-damaged premises for the period during which they are rendered untenable. We must remember, however, that rates would continue to be payable in full following a fire causing less extensive damage, even though it had the effect of seriously dislocating the business. Consequently, the item of rates should properly be insured as a standing charge, seeing that the amount so payable is one of the overhead charges which ordinarily have to be met out of the earnings of a business before any net profit is obtained. Assuming, however, that the charge does, in fact, cease for a period, the amount recoverable under the first contractual clause would need to be appropriately adjusted, for a part of the sum insured is definitely allocable to the item of rates, and, as events have shown, no loss was actually sustained by the Insured under that heading.

Clause (b).

The second clause of the policy deals entirely with those items of additional expense which are incurred with the object of maintaining the business and so reducing the loss which would otherwise fall to be payable under clause (a). It commences—

(b) Increase in cost of working necessarily incurred by the Insured in consequence of such interruption or interference in order to maintain during the period of indemnity turnover not exceeding that of the corresponding period in the twelve months immediately preceding the fire. . . .

One or two points call for notice. We may first observe that, to be recoverable under the clause, the items of expenses must be *necessarily* incurred, and only to the extent that is needed for the maintenance of business at its normal level. The Insured will perhaps be anxious—not unnaturally—to do more than maintain

it. He would wish to increase it if possible, but the Insurance Company is interested only in avoiding or minimizing the loss under Clause (a). Subject to the terms of the policy it is prepared to bear the additional cost of so doing, but when business regains the level at which all loss under Clause (a) ceases—in other words, when the business is fully maintained at its normal level—the Insured alone benefits by any increase in business beyond that point, and should, therefore, bear that part of the additional cost which relates to the expansion of business.

We may note, moreover, that the Increase in Cost of Working must be directed towards the maintenance of business during the period of indemnity only—the period during which trading losses are recoverable under Clause (a). If the expenditure incurred is such as will benefit the Insured after the period of indemnity has expired, it is only equitable that he should bear his proportion of such expense.

It will be appreciated that the cover afforded by Clause (b) is really *alternative* to that of Clause (a), rather than additional to it. If business is actually stopped by fire—if, in other words, a total loss is being sustained under the first clause—then no Increase in Cost of Working is being incurred, seeing that no work is being done, and Clause (b) does not, therefore, operate. It may be, of course, that losses are being simultaneously incurred under both heads, for business may be only partially maintained by the expenditure of increase in cost. Obviously, however, the additional cost incurred to maintain business should not be greater in amount than the profits accruing from the business that is so maintained, otherwise the loss is being enhanced, instead of diminished, by the measures that are being adopted. Such a position would be tantamount to an expenditure on salvage operations greater than the value of the property at risk. It is clearly an unsound business proposition to expend, say, £120 to avoid a loss of £100, and it is not unusual to embody a proviso in Clause (b) to deal with the point, reading—

... provided that the amount payable in respect of increase in cost of working shall not exceed the additional amount that would have been payable in respect of loss of profits under clause (a) had no such increase in cost of working been incurred.

There is invariably inserted in Clause (b) a proviso which applies the principle of average to items of Increase in Cost of Working.

As we have noted, average is automatically embodied in the provisions governing the recovery of losses in respect of profits. The Insured and his Insurer participate, in proportions determined by the extent of the insurance, in losses which relate to net profit and specified standing charges. Expenditure incurred to avoid or diminish such losses, therefore, benefits both parties in the same proportions and should be shared accordingly. The proviso reads—

... provided that if the sum insured by this policy shall be less than the sum of the net profit and all standing charges (insured and otherwise) of the business for the last financial year preceding the fire the amount payable shall be proportionately reduced.

It will be seen that the full insurable interest for the application of average is stated as the net profit of the business and *all* standing charges, whether insured or not. The word “profits” cannot be used in this connection, for its meaning has already been stated as “net profit” and *specified* (i.e. “insured”) standing charges. It may be that the Insured has neglected to specify and insure some of his charges which do, in fact, continue to be payable in full after a fire. Consequently, his sum insured is smaller than it should have been, and he becomes his own insurer for the difference—for that part of the loss which relates to those uninsured charges which continue. There is thus a community of interest in the additional cost incurred to maintain the business, and in equity both parties should share the expenditure proportionately.

Total Liability.

So far the policy has dealt separately, under clauses totally distinct, with each of the loss categories in respect of which it indemnifies. There now follow limitations which govern the total payments under the policy as a whole. They read—

Provided that the total liability of the Company shall not exceed in respect of any fire the sum which would be payable if the turnover were entirely stopped by the fire during the period of indemnity, nor in the aggregate in respect of all fires during the annual currency of the policy, the sum insured.

To some extent the first part of the above proviso covers the ground already traversed by the clause we have already referred to as being sometimes embodied in Clause (b) to prevent expenditure for Increase in Cost greater in amount than the profits earned by the business so maintained. Whilst both embody the same principle, they are not entirely identical in effect. The proviso we

are now considering imposes a limitation of policy liability which prevents the Insured from recovering more than that part of his sum insured which relates to the period of indemnity. The former is a proviso governing the payment of Increase in Cost of Working generally, and it applies irrespective of whether the loss is partial or total in extent. If, for instance, only one of a number of machines were destroyed by fire it would have the effect of limiting the amount recoverable in respect of Increase in Cost to the amount that the damaged machine would have been capable of earning had the fire not occurred.

The proviso last quoted forms part of the "total liability" clause, and should be read as such. We must bear in mind that, in connection with profits losses, a definite time factor is introduced, namely, the period of indemnity. This may prove to be, say, three months, either because the actual period of interruption is of that duration or else because the Insured elected, when effecting the insurance, to limit the Company's liability to a period of three months after any fire. We have seen that the insurance should be effected for the amount of the annual net profit and standing charges, and a three months' stoppage of work would involve a loss equal to the earning capacity of the business during that particular period of the year. Whether it will be more or less than one-quarter of the annual profits will depend upon whether the period of interruption occurs during the Insured's busy or slack season. The object of the first part of the total liability clause is to make it clear that the total amount recoverable in respect of loss of profits *and* increase in cost of working must be limited to the amount that would have been payable under Clause (a) in the event of a total stoppage during the period of indemnity. The second part of the clause relates to the total of all payments in respect of all fires during the annual currency of the insurance. Even if a business should be totally stopped throughout the whole length of a period of indemnity of less than twelve months, the unexhausted part of the sum insured still remains available for losses caused by any further fires that may occur during the unexpired period of the insurance, but the total liability of the Company must clearly be limited to the sum insured ; otherwise an Insured who selected, say, a nine months' period of indemnity, might recover

a total loss for that period following a fire early in the currency of the insurance, and expect to be reimbursed fully for a further period of nine months if a second fire should occur in the same term of insurance. The total liability clause makes it clear that he must appropriately reinstate his insurance if he desires to be adequately covered in respect of any further fires that may occur before the expiry of the insurance.

Fire.

It only remains to consider the special definition of the term "Fire" that is utilized in connection with Profits Insurances, and our examination of the face of the ordinary type of policy is complete. The definition runs as follows—

Fire. Fire, lightning, explosion of gas used for light, heat, or power and boiler, and/or economizer explosion.

The most interesting point of difference between this definition and that which applies in connection with fire insurance is the inclusion of boiler and economizer explosion. It is not easy to assign any particular reason why this important extension should be associated with Profits Insurances, but it was probably introduced to meet a particular demand when the business was in its infancy. To-day, however, liability for loss of profits following boiler and economizer explosion is generally recognized as forming part of the cover of a profits policy.

Before illustrating the operation of the policy by a hypothetical case, we might now review the face of the document as a whole and see in what manner it has been constructed to give effect to the principles that have been enumerated in the previous chapters. It will be convenient to tabulate the objects it sets out to achieve, and against each to indicate the particular part of the policy which gives effect to the point.

PURPOSE.

1. To make the contract one of indemnity.

REFERENCE.

Clause (a) and the words which precede it viz. : "The Company will indemnify the Insured . . . in respect of loss of profits *sustained* but not exceeding . . ." Also . . . "If any of the specified standing charges shall be reduced the amount payable shall be reduced accordingly.

PURPOSE.

2. To set up a standard to represent the normal activity of the business during any given period.

3. To determine the proportion of business lost which represents loss to the Insured.

4. To apply the principle of average.

REFERENCE.

Clause (a) "the turnover of the corresponding period in the twelve months immediately preceding the fire."

Definition of "Ascertained Percentage" . . . "but not exceeding the percentage of profits in the last financial year preceding the fire to the turnover for that period."

Definition of "Ascertained Percentage" . . . "The percentage of the *sum insured* to the turnover of the twelve months immediately preceding the fire."

Clause (b). "Provided that if the sum insured be less than the sum of the net profit and *all* standing charges (insured and otherwise) for the last financial year, the amount payable shall be reduced proportionately."

Example of Loss Settlement.

We will now reduce the working of the policy to figures, and see how it operates in the case of a simple loss. We will assume for this purpose that the circumstances are as under—

Sum insured	£ 6,000
Period of indemnity, 12 months.	
Profits of last financial year	10,000
Net profit and all standing charges last financial year	12,000

A fire affects the business for six months—

Turnover for period in twelve months preceding the fire corresponding with period of indemnity	£ 25,000
Turnover during period of indemnity	7,000
The shortage is thus.	£18,000

Turnover for twelve months immediately preceding the fire	£ 40,000
Turnover during last financial year was also	40,000

The percentage of the sum insured (£6,000) to the turnover twelve months before the fire (£40,000) is 15 per cent. The percentage of profits in last financial year (£10,000) to turnover of that period (£40,000) is 25 per cent. The "Ascertained Percentage" is, therefore, 15 per cent.

The "Ascertained Percentage" (15 per cent) of shortage £18,000 is	£ 2,700
The "Increase in cost of Working" is agreed at	£1,000.
As the sum insured (£6,000) is less than the sum of the net profit and <i>all</i> standing charges of last financial year (£12,000) average applies and $\frac{6,000}{12,000}$ of £1,000 is recoverable under	
Clause (b).	500
Total	<u>£3,200</u>

In the foregoing example it has been assumed, of course, that all conditions of the policy have been satisfied.

It will be seen that the risk was considerably under-insured, and average therefore applies. In point of fact, the loss is shared equally throughout between the Insured and the Company. This is clearly so in the case of the amounts expended for Increase in Cost of Working, for the amount recoverable under the policy is only half of the total so expended. In regard to Clause (a), however, it will be seen that the Insured has failed to specify and insure certain standing charges amounting in all to £2,000 annually. He accordingly bears the whole of the loss incurred in connection with such charges, seeing that they are not insured, and this represents 5 per cent of his turnover. He loses a further 10 per cent by reason of under-insurance in connection with the charges he *has* specified, for we see that the first part of the definition of "Ascertained Percentage" yields 15 per cent, whereas the actual percentage of profits to turnover is 25 per cent. He loses, then, 15 per cent of the shortage in all, and recovers a like percentage under the policy. In fact, as the sum insured is only one-half of the total of his net profit and all standing charges, the policy provides him with one-half of his loss under both headings, leaving him, as his own insurer, to bear the other half.

CHAPTER V

Policy conditions—Financial year—Net profit—Liability for fire damage to be admitted—Liquidation of a business after a fire—Extraordinary circumstances—Unearned standing charges—Alteration of fire rate.

BEFORE we turn our attention to other forms of policy, embodying standards of normal activity other than the turnover of the corresponding period in the previous year, it is necessary first to consider the policy conditions, which we should note are applicable to all profits contracts, irrespective of the system of measurement they embody. For convenience these are set out in Appendix IV, and in this chapter we will examine each in turn.

Financial Year.

Condition No. 1 consists of two additional definitions. The first reads—

Financial Year. The year ending on the day to which in the ordinary course of the business the yearly accounts are made up.

Without such a stipulation in the policy there would be nothing to prevent an unscrupulous insured from altering after a fire the closing date, or even the length, of the period covered by his last financial year and by so doing bring into—or leave out of—his last accounts the transactions of a certain period not ordinarily covered by his usual accountancy year and so improve his ratio of profits to turnover during that period. We must remember, too, that average is usually applied to increase in cost of working on the basis of the results of the last financial year, and it is important that the full insurable amount for the purpose of average should not be capable of adjustment (after a fire) by so simple an expedient as the alteration of accountancy dates. The definition makes it clear that the references in the policy to the last financial year relate to the ordinary period usually covered by the Insured's accounts. The Insured may not benefit by retrospectively making up his last financial year's figures for a period other than that usually embraced by his accounts

Net Profit.

The second definition relates to net profit and reads—

Net Profit. The profit arising from the trading of the insured in respect of the business in the premises after proper provision has been made for all standing and other charges, all capital receipts and accretions, and all outlay properly chargeable to capital and depreciation.

Having regard to the varying methods adopted by different firms in arriving at their net profit, a definite understanding as to what is meant by the term in connection with Profit Insurance is necessary. Our purpose must be to express in explicit terms that we are concerned only with the profit earned by the business we are insuring, after all expenses incidental thereto have been met or properly provided for. The Insured, for the purpose of his accounts, may, for instance, bring in certain receipts (such as interest on investments) which, from a Profit Insurance point of view, are quite foreign to his trading activities in connection with the "business" insured. Similarly, it may be convenient to him to charge certain expenses properly debitable against the "business" to the account of some other business, not included in the insurance, or to charge against a certain year's trading charges which should properly be debited to the trading of some other period. For the purpose of Profit Insurance, we must define net profit to mean *legitimate receipts* less all *legitimate charges*, namely, those which should properly be charged against the trading of the Insured at his business.

Condition 2 contains a number of exclusions from the scope of the cover, similar in character to the corresponding exclusions of a fire policy. It should be noted, however, that a number of the perils excluded (as for instance riot, civil commotion, explosion) can, if desired, be specifically added to the perils insured against, subject to an appropriate adjustment of premium, just as they can in the case of fire insurance. When such additions are arranged, it is usually done by amplifying the definition of the term "fire" on the face of the policy.

Admission of Liability.

The condition concludes with an important provision regarding the insurance against material damage of the property damaged or destroyed—

Nor will the Company be liable for any loss under this policy unless the Insured's property destroyed or damaged by fire in the premises is insured against damage by fire, and the Company or Companies by which such property is insured against damage by fire shall have paid for or admitted liability in respect of such damage.

At first sight it might perhaps appear that, with this safeguard, the first three sections of the conditions are superfluous, in that corresponding exclusions are practically certain to govern the fire insurance, the existence of which is here made a condition precedent to the right of recovery under the profits policy. It is to be borne in mind, however, that the fire policy may have been extended to include, say, riot and civil commotion, but that the necessary additional premium for a like extension of the profits policy had not been paid to the Company. In such a case the exclusions in the profits policy would relieve the Insurer of liability to pay for loss sustained through a peril in respect of which it had received no premium.

The definite linking up in this manner of a profits policy with one covering material damage is of considerable utility. In the first place, it obviates the repetition in the profits policy of a number of conditions and warranties governing the fire hazard which would otherwise have to be embodied therein, in addition to those which are essential for the regulation of the profits risk. It is by no means an uncommon thing for the profits risk to be insured with one Company and the fire risk with another. So to associate the two policies together greatly simplifies the transaction of Profits Insurance, obviating periodical surveys and policy revisions following alterations of fire hazard. Moreover, it is of great assistance in connection with profits loss settlements. Independent investigation of the origin of fires are thus rendered unnecessary in profits claims, whilst to some extent at least the condition ensures that the profits loss shall not be aggravated by the fact that the Insured has not the necessary capital to replace the fire damaged property.

Here it might be observed that the definition of the word "fire" on the face of the policy applies wherever the word appears on the document, whether on the face of the policy or among the conditions on the back. We must recollect that the word extends to include boiler and economizer explosion. Should such an explosion occur, it may be regarded as a fire within the meaning

of the policy, but there is imposed on the Insured the obligation to have insured his boiler or economizer against explosion, and the Company concerned must have admitted liability before the profits policy operates. Obviously, the word "fire" cannot have one meaning on the face of the policy, and a more limited meaning elsewhere on the same document.

Condition 3 recites the circumstances which void the insurance. Most of these are applicable to fire and other insurances, in that they relate to misstatement, fraud, and the increase of hazard without the sanction of the Company. It is curious to note that, in connection with the last mentioned, the condition applies only to increase of *fire* hazard, not to what is termed the "interruption risk." The possibility of a business being seriously interrupted by fire might be greatly enhanced without any increase of fire hazard, as, for instance, by a concentration of dies and patterns in one location. If these are destroyed, it may be that work entirely ceases until they can be replaced. To store them in one room may thus affect the interruption hazard materially, but Condition 3(b) might not apply. The risk of fire may, in fact, be actually reduced if the dies and patterns were stored—as they probably would be—in a location less exposed to fire risk than if they were stored at different places throughout the works.

Liquidation of Business.

Condition 3(c) also calls for comment. It reads—

The policy will be void . . . if the business be liquidated or permanently discontinued after a fire.

The purpose of this condition is to safeguard the Company in the event of the Insured abandoning his business after a fire, thereby converting into a total loss one which might otherwise have been partial only. If the Insured permanently discontinues his business after a fire the position which is created is very similar to that which would arise in connection with fire insurance if the Insured, observing a fire break out in his premises, makes no effort to extinguish it, but stands idly by while the whole of his property is being destroyed. It is incumbent upon the Insured to make every possible effort to re-establish his business after a fire, and our next policy condition lays emphasis in this. Voluntarily to liquidate

a business after the occurrence of a fire would be incompatible with the due fulfilment of the Insured's obligations in this respect, and Condition 3(c) affords a useful safeguard to the Company. Without it, a profits policy would be likely to prove an irresistible attraction to an Insured who, foreseeing the necessity of closing his business at an early date, confidently anticipates that a fire will occur to retrieve his fortunes. It is not intended, of course, to penalize an Insured who is genuinely unable, from circumstances entirely beyond his control, to carry on his business after a fire.

Condition 4 imposes the reasonable time limit of 30 days after the expiry of the period of indemnity for the presentation of a detailed claim, but an extension of time can, of course, be agreed upon between the Insured and Insurer if the circumstances warrant it. It also requires the Insured to produce all reasonable evidence in support of his claim, and stipulates that he shall

use due diligence and do and concur in doing all things reasonably practicable to minimize any interruption of or interference with the business and to avoid or diminish the loss.

It is, of course, as much in the interests of the Insured as of the Insurer that the period of interruption should be curtailed as much as possible. Valuable connections may permanently be lost if a business house is temporarily out of the market, and it is to be remembered that the right to recover under the policy trading losses so caused is subject to the time limit embodied by the definition of the period of indemnity. Condition 4 imposes a definite obligation on the Insured to take all possible steps to maintain his business, and, as we have seen, Clause (b) of the policy indemnifies him in respect of the additional cost he incurs in doing so.

Extraordinary Circumstances.

Condition 5 reads—

In adjusting the amount of indemnity, account shall be taken of any variations in the business of the Insured, and an equitable allowance made in the turnover for all extraordinary and other circumstances of the business.

Without this condition it would be futile for the policy to emphasize that its purpose is solely one of indemnity, for any preconceived plan of operations is likely to be upset by unforeseen happenings, and this is particularly the case in connection with the

settlement of profits losses. The example usually cited of an "extraordinary circumstance" is a strike of workpeople, occurring either during the period of indemnity or during the period which provides the standard turnover against which shortage is measured, but epidemics, floods, machinery breakdowns, weather and market conditions, and periods of national mourning are further instances of happenings which may clearly necessitate some adjustment of the result obtained by applying the system of measurement outlined in the policy. If the condition were omitted, the amount recoverable would be arbitrarily fixed by the trading results of the corresponding period in the twelve months before the fire, and such results might obviously have been more or less favourable, by reason of conditions then prevailing, than would have been the case during the period of indemnity had no fire occurred. As it is, the condition operates as much in the interests of the Insured as of the Insurer. The former can, perhaps, adduce evidence that the period which provides the standard of normal activity was artificially depressed by reason, perhaps, of building operations then being carried on in his premises, or that some circumstance prevailing during the period of indemnity would certainly have beneficially affected his turnover during that period. Similarly, it is competent for the Insurer to require adjustment in respect of any special circumstance which unquestionably inflated the turnover during the period which is taken to furnish the standard of normal activity, or which would adversely have affected business during the period of indemnity. Despite the elasticity of the wording and the very wide scope of the condition, it has worked extraordinarily well in practice.

Unearned Standing Charges.

Condition 6 deals with the position created when a business is working at a loss. It reads—

The amount insured in respect of any standing charges specified in the policy shall only apply to the extent to which they shall have been or would have been met by the earnings of the business in respect of the period upon which the insurance is based.

Should a fire occur and interrupt a business at a time when it would not have earned sufficient to pay its standing charges—when, in fact, it would have produced a net loss if no fire had

occurred—the Insured is entitled to recover only in respect of the *additional* loss brought about by the interruption of business through fire. It would be contrary to the principle of indemnity to relieve him of a loss—or of any part of a loss—which he would in any event have been called upon to face if his business had not been interfered with. The condition, therefore, provides that if a business “shall have been or would have been” earning only a proportion of its standing charges, the insurance in respect of standing charges shall apply only to that extent. This is entirely in accord with the declared purpose of the insurance to “indemnify in respect of loss of profits *sustained*.”

Then follow conditions dealing with (a) contribution between offices in the event of there being other subsisting insurances, (b) the subrogation of the Insured's rights of recovery against any other party, and (c) the settlement of disputes by arbitration. These do not differ from the corresponding conditions of a fire policy and call for no comment here.

Alteration of Fire Rate.

It is usual to add at the conclusion of the policy conditions a memorandum requiring notification if the rate for fire insurance be increased. This may appear to be unnecessary in conjunction with the condition which voids the contract if the fire hazard be increased, but it should not be overlooked that fire rates for a particular *class* of risk are sometimes revised without the importation of additional hazard in the individual risk. Probably this memorandum is a survival of the days when profits insurance was transacted by only a few of the smaller Companies, the fire risk being placed elsewhere. To-day, the general position is very different, but, although the requirement contained in the memorandum has been retained in the policies, it is no longer made the subject of a policy condition proper, but is embodied rather in the form of a note for the guidance of the insured as to the requirements of the Company.

CHAPTER VI

Increasing business policy—Annual equivalent policy—Commencing businesses policy—Average of years—Departmental policies—Warehouse and shops policies—The sum insured.

THE form of policy we have hitherto considered is obviously unsuited to the requirements of a progressive business, for its system of measurement is based on the assumption that the results of the previous year may be taken as an indication of the probable earnings of the business during the ensuing year. With a progressive business it may clearly be anticipated that the results of the previous year will be exceeded, and, therefore, the simple form of policy dealt with in Chapter IV is inapplicable. If we examine it afresh, keeping in mind the requirements of an increasing business, we shall see that revision is needed in two important respects. Our attention is first arrested by the reference in Clause (a) to "the turnover of the corresponding period in the twelve months immediately preceding the fire," and it will be obvious that, for a progressive business, we need some other standard of normal trade activity—one which will take into account the expansion of business that would ordinarily have taken place *since* the corresponding period in the last twelve months. Continuing a re-examination of the ordinary form of policy, we find, too, that it is unsuited to the needs of an increasing business in that it does not make proper provision for the application of average. This first becomes apparent in a perusal of Clause (b), wherein the full insurable interest is stated as the "net profit and all standing charges (insured and otherwise) for the last financial year." There can be no doubt that the sum insured should be a larger figure than that if the business is progressive, otherwise no provision is made for the anticipated expansion of business. The first thought that occurs to us is that the figures of the last financial year must obviously be increased by the rate at which the business is expanding year by year, but a little reflection will show that even if the figures of the last financial year were so increased, the sum insured would still be insufficient properly to protect the Insured throughout the whole term of insurance. We must bear in mind that the indemnity

recoverable under a profits policy relates, not to the earning power of the business at the *time of the fire* but to the profits that it would have earned during a period *following* a fire. Consequently, we must look farther ahead than the current term of the insurance. Assume, for instance, that a business consistently increases at the rate of 10 per cent yearly, and that, at the close of a financial year which discloses profits of £10,000, the question of the sum to be insured is under consideration. The earnings of the years with which we are concerned may be depicted as follows—

A			B	
last year	:	current year	:	next year
: £10,000	:	£11,000	:	£12,100 :

FIG. 7

By applying the annual ratio of increase to last year's profits of £10,000, we may reasonably estimate those of the current year at £11,000, but if a fire should occur towards the end of the term, the period of indemnity might extend over the period shown at B, during which earnings of about £12,000 may confidently be anticipated. Consequently, an insurance effected at the commencement of the current year (A) should, to obtain the fullest measure of protection, be for a sum approximating the probable earnings of the period B. It cannot be said, however, that sums insured for increasing businesses are usually computed in this manner. For practical purposes it is generally considered sufficient that the figures of the last financial year should be increased by the appropriate annual ratio of expansion, and in policies issued in connection with increasing businesses average does not in fact operate in respect of Increase in Cost of Working unless the sum insured is less than the sum of the net profit and all standing charges earned *during the annual currency of the insurance*, but such a sum is clearly insufficient to provide fully for a twelve month's total interruption following a fire towards the end of the term of insurance.

As we have previously noted, average is automatically applied to loss of profits in arriving at the "Ascertained Percentage." Here, again, the wording of the ordinary policy obviously needs amendment to meet the requirements of an increasing business.

Admitting that the sum insured must be appropriately increased to a figure in excess of the earnings of the last financial year, we see that, to compare such increased sum insured with the "turnover for the twelve months immediately preceding the fire" would give a percentage larger than the ordinary rate of earnings. Assume, for instance, that in the example cited in Fig. 7, an insurance had been effected for £11,000 at the commencement of the current year, and that a fire occurred within a very few days. The turnover of the twelve months immediately preceding the fire would be approximately the same as the turnover of the last financial year, for the two periods would be almost identical. The percentage of the sum insured to the turnover of the twelve months immediately preceding the fire would obviously be greater than the normal percentage of profits to turnover. In fact, a sum insured of £10,000 only would be sufficient to yield the correct percentage, for that figure represents the profits of the last financial year, and if applied to the turnover of what is approximately the same period, it would obviously give us (although £10,000 is less than the full insurable amount) the normal ratio of profits to turnover. Clearly, some adjustment is necessary here, and if the principle of average is to be maintained, the increased sum insured must, in arriving at the "Ascertained Percentage," be applied to an annual turnover which has also been correspondingly increased.

Increasing Business Policy.

To meet the requirements we have noted of a business which is expanding year by year, a form of policy is utilized known as the Increasing Business policy. Its main features are the embodiment of an ever-increasing standard of normal activity, and, in order that average may correctly be applied, a definition which enables the assumed annual turnover to be calculated with due regard to the rate at which the business is expanding. The wording is given at Appendix V, and it will be noted that three new definitions are introduced. The first to engage our attention is the "Percentage of Increase," which establishes the rate at which the business is expanding at the time of the fire. It reads—

Percentage of Increase. The percentage shown by comparing the turnover for the six months immediately preceding the fire with the turnover for the corresponding period in the preceding twelve months.

The Increasing Business policy is based on the reasonable assumption that, if the fire had not occurred, the business would have continued to expand at the same rate of increase that was being manifested in the period preceding the fire, as compared with its results in the corresponding period in the previous year. The definition establishes that rate of increase, and thereby enables us to set up our standard of normal trade activity. This is embodied in the definition of "Estimated Turnover," which runs—

Estimated Turnover. The turnover for the period in the twelve months immediately preceding the fire corresponding with the period of indemnity, to which shall be added the "Percentage of Increase."

Against this standard is compared the turnover actually maintained during the period of indemnity in order to arrive at the shortage.

We have already noted that in arriving at the "Ascertained Percentage," the annual turnover must be calculated with due regard to the expansion of the business, and this is provided for. The definition of "Ascertained Percentage" introduces the term "Annual Turnover," which is separately defined as—

Annual Turnover. The turnover for the twelve months immediately preceding the fire to which shall be added the percentage of increase.

Not infrequently the policies are adapted to operate in respect either of an increase or a *decrease* in Turnover, in which event the definition governing the establishment of the percentage of increase or decrease is usually termed the "Percentage of Adjustment."

In Clause (b) it will be seen that, as already mentioned, the insurable amount is given as—

the sum of the net profit which would have been earned and all standing charges (insured and otherwise) of the business which would have been incurred during the annual currency of the policy had the business not been interrupted or interfered with.

Sometimes it is more definitely stated as—

The net profit and all standing charges of the business (insured and otherwise) for the last financial year preceding the fire to which shall be added the percentage of increase.

If the insurance has been effected for an adequate amount, the Insured recovers in the event of fire his usual percentage of profits on the shortage in turnover caused thereby, such shortage being

measured from a datum line so defined as to afford him full benefit during the period of indemnity of the same rate of expansion as he has attained during the year preceding the fire. If, for instance, the Insured has reason to expect a 20 per cent increase in his business over the figures of the previous year, he should increase his profits of the last financial year by at least 20 per cent and insure accordingly. If the anticipated expansion of 20 per cent does, in fact, take place, he automatically recovers his usual percentage of profits on any shortage, for his sum insured (last year's profits plus 20 per cent) will be compared with his "Annual Turnover" (turnover of previous twelve months plus 20 per cent), and as both figures have been increased proportionately, the resultant percentage should approximate the actual percentage of profits to turnover in the last financial year. If, however, the fire should occur towards the end of the term of insurance, the turnover of the twelve months before the fire will, in the natural order of things, be appreciably in excess of that of the last financial year, and when it is increased by a further 20 per cent (percentage of increase) the percentage obtained by comparing the sum insured with such adjusted "Annual Turnover," will obviously be somewhat less than the usual percentage of profits to turnover. To meet this position, a special "Adjustment of Premium" clause is often inserted in such policies, under which the Insured can claim a refund of a proportionate part of the premium (limited to 50 per cent) if the profits actually earned during the term of the insurance fall short of the sum insured. With such a clause it is open to the Insured to take out his insurance for an amount somewhat in excess of his anticipated profits in the twelve months immediately ahead, thus ensuring the recovery of his full normal percentage of profits on any shortage irrespective of whether it occurs at the beginning or end of the term of insurance. To be properly covered throughout, he should, as we have seen, insure for the amount of his profits in the last financial year, to which has been *twice* applied the anticipated ratio of increase, and claim an appropriate rebate of premium at the expiry of the insurance. The Insurer is, of course, protected against the possibility of being called upon to pay more than an indemnity by the limitation imposed in the latter part of the definition of "Ascertained Percentage."

The following simple example will illustrate the working of the policy—

Profits last financial year	£	5,000
Anticipated Profits ensuing year		6,000
Sum insured		6,000
Fire interferes with business for three months.		
During six months preceding the fire turnover was		30,000
During corresponding period in previous year it was		25,000
"Percentage of Increase" is thus 20 per cent.		
During period in previous year corresponding with the period of indemnity the turnover was		10,000
Add 20 per cent		2,000
		<hr/>
"Estimated turnover" is thus		12,000
The turnover during period of indemnity was		4,000
		<hr/>
The shortage in turnover is thus		£8,000
		<hr/>
Turnover for twelve months preceding the fire was		50,000
Add 20 per cent		10,000
		<hr/>
"Annual Turnover" is thus		£60,000
		<hr/>
The percentage of the sum insured (£6,000) to the "Annual Turnover" (£60,000) is 10 per cent.		
Assuming turnover of last financial year also to have been £50,000 the percentage of profits to turnover during that period was also 10 per cent.		
"Ascertained Percentage" is thus 10 per cent.		
Apply "Ascertained Percentage" to shortage in turnover (10 per cent of £8,000)	£	800
Increase in cost of working, say.		100
		<hr/>
Amount recoverable		£900

We have assumed that the fire occurred at the commencement of the new financial year, for the turnover of the twelve months preceding the fire was the same as that of the last financial year. Had an appreciable period intervened between the close of the last financial year and the date of the fire, the turnover of the twelve months preceding the fire would naturally, by reason of the expansion of the business, have exceeded that of the last financial year. The "Annual Turnover" would then have been greater than £60,000, and this would have the effect of reducing the "Ascertained Percentage," leaving the Insured to bear a portion of the loss himself. On the other hand, it should not be overlooked that,

although the ascertained percentage would have been somewhat reduced, it would have been applied to a greater shortage in turnover, seeing that the "Estimated Turnover" would also have been substantially increased during the intervening months.

It has been assumed, too, that all standing charges of the business were insured, and that average was not applicable to increase in cost of working.

Annual Equivalent Policies.

A somewhat unsatisfactory form of policy, which is not now utilized to any appreciable extent, is known as the "Annual Equivalent" policy. In this form of contract, the standard of normal trade activity is stated as the average monthly turnover for, say, three or six months before the fire. Annual equivalent policies were regarded as appropriate to the needs of a business which, by reason of exceptional trade depression or other cause, had passed through a period of trading, the results of which would not be likely to afford a useful guide in the establishment of its probable yield for the future. As will be appreciated, the increasing business policy would be much more likely to measure correctly the amount of loss sustained after a fire in such a case, particularly if it were adapted, as it frequently is, to operate both in respect of a *decrease* in business as well as an increase. For some reason, however, probably because of their simple phraseology, annual equivalent policies were freely used during those years of chaotic trading conditions brought about by the war, and, in fact, were frequently issued in cases to which an increasing business policy was clearly applicable. The Insured, perhaps, derived some measure of comfort from the fact that, in establishing the shortage of turnover, the business of the previous year was not utilized at all. Sometimes, too, the earnings of the last financial year were not referred to in the definition of "Ascertained Percentage," the limit imposed being the percentage of profits to turnover of, say, the three months before the fire. As we have seen, it is usually not practicable to determine the net profit of any broken term, but only of a complete accountancy period, and, consequently, such a limitation would not be likely to be of practical value in many cases. The chief weakness of the policy, however, lies in

the fact that most businesses are seasonal in character to some extent, and, consequently, the average monthly turnover of three or six months before the fire will, in all probability, be less than, or in excess of, the turnover that might be expected during each month of the period of indemnity, according to whether the fire occurs after a busy period or a slack one. If a business is at all seasonal in its operations, the object of the policy (*viz.* : to indemnify) is indifferently carried into effect by adopting an average monthly turnover as the standard against which to measure shortage. The difficulty is by no means overcome by taking, as is sometimes done, the average turnover of the *twelve* months before the fire, and any settlement under these policies is likely to need substantial adjustment to conform with the requirements of indemnity.

A typical "Annual Equivalent" policy is given in Appendix VI.

Commencing Business Policies.

A form of contract which presents all the disadvantages of the annual equivalent policy is the one known as the "Commencing Business" policy, but it can at least be urged that, in connection with a business that has been recently established, no alternative basis is practicable. Where it is desired to issue a policy covering a new business, it is obvious that for the purpose of loss measurement recourse must be had to the only available trading experience, namely, that of the period from the commencement of the business to the date of the fire. Consequently, we must take the average monthly turnover of that period in setting up the standard turnover against which shortage is to be measured and calculate an annual equivalent of that turnover for the purpose of arriving at the ascertained percentage. All that has been said in regard to the annual equivalent policy in relation to the "seasonality" of the business applies equally, of course, to the "Commencing Business" policy, but as the insurance of the profits of a newly established business must necessarily be of a rather speculative nature, a somewhat restrictive policy is not entirely unjustifiable.

As the average results of the earlier months of a newly established business are, in the natural order of things, likely to be exceeded

even in the later months of the first year, the average monthly turnover is sometimes stated as—

the average monthly turnover for the three months immediately preceding the fire or of the period from the commencement of the business to the date of the fire, whichever shall be the less ;

but in any event, the commencing business policy is to be regarded as a temporary form of contract, to be abandoned in favour of one of a more satisfactory and permanent type, as soon as the requisite length of trading experience has been attained. A copy of the policy is given at Appendix VII.

Average of Years.

In certain businesses it is found that the turnover fluctuates very materially from year to year, the busy periods, perhaps, occurring at different times of the year for reasons unconnected with ordinary seasonal considerations. In such cases there can be no advantage in basing loss settlements on the results of the corresponding period in the previous year, and a stabilizing effect can be attained only by taking the average results of the corresponding period over a number of years. Requests for insurances on this basis are not infrequently inspired by the fact that the business has shown a consistent decrease during the past few years, and, obviously, it is undesirable in such cases to issue this form of policy, but the basis can usefully be employed where the turnover of one year is likely to be appreciably below or in excess of another. A policy on these lines is given in Appendix VIII, and it will be noted that the average result of a stated number of years is taken in calculating (a) the standard of normal activity during the period of indemnity, (b) the annual turnover, and (c) the full insurable amount for the purpose of applying average to Increase in Cost of Working. In all forms of profits policies, consonance is observed throughout in these respects, thereby ensuring that the annual sum insured is recoverable under Clause (a) only in the event of a total stoppage of business for twelve months. If this were not so—if, for instance, the annual turnover were calculated on a basis which would yield a figure proportionately smaller than should be the case in relation to the figure adopted as the standard turnover for the period of indemnity—the resultant “Ascertained Percentage” might be such

that the sum insured would be exhausted during a period of interruption of less than twelve months. Assume, for example, that the turnover of a certain business during the past three years amounted to £20,000, £30,000, and £10,000. An insurance based on the average results of the past three years would seem to be the most appropriate, and any shortage in turnover would accordingly be measured against the *average* turnover of the periods corresponding with the period of indemnity. In the same way, to arrive at the ascertained percentage, the sum insured would be compared with the *average* turnover of the three preceding years; in this case £20,000. Lack of uniformity in these respects throughout the policy might yield chaotic results. If, to illustrate the point, we failed to observe the rule and utilized the turnover of last year only (£10,000) to calculate the ascertained percentage the result would be twice as large as it should be, and in the event of under-insurance, the whole sum insured might become payable following a loss of only half the average annual turnover.

In selecting an appropriate form of policy, our aim must be to choose one which will set up a standard of normal trade activity which, as nearly as may be judged, will represent the amount of business that would ordinarily have been maintained had no fire occurred. The avowed intention of the policy is to "indemnify in respect of loss of profits sustained," and the system of measurement embodied therein will operate to that end if it is appropriate to the needs of the particular business concerned. An unsuitable form of policy, however, is likely to yield a result which will obviously need considerable adjustment if the purpose of the policy is to be achieved. It is unquestionably advisable that the amount of adjustment under Condition 5 of the policy should be limited, as far as possible, to that necessary by reason of "extraordinary circumstance"—contingencies which could not possibly have been foreseen. There should be no occasion to put the condition into operation for circumstances other than these if an appropriate form of policy has been issued, and, consequently, it is important that the policy should be chosen with due regard to its obvious requirements. Each form of policy that has engaged our attention has been drawn up to meet a certain need. In each, the standard of normal activity that it sets up is suitable for the type of business for which

it has been designed. To illustrate the different results that would be yielded by inappropriate forms of policy, we will diagrammatically represent the turnover of a business that has steadily increased during the past three years. For such a business, an "Increasing Business" policy is clearly indicated, and the standard of trade activity that it sets up is shown by the dotted line *A* which forms

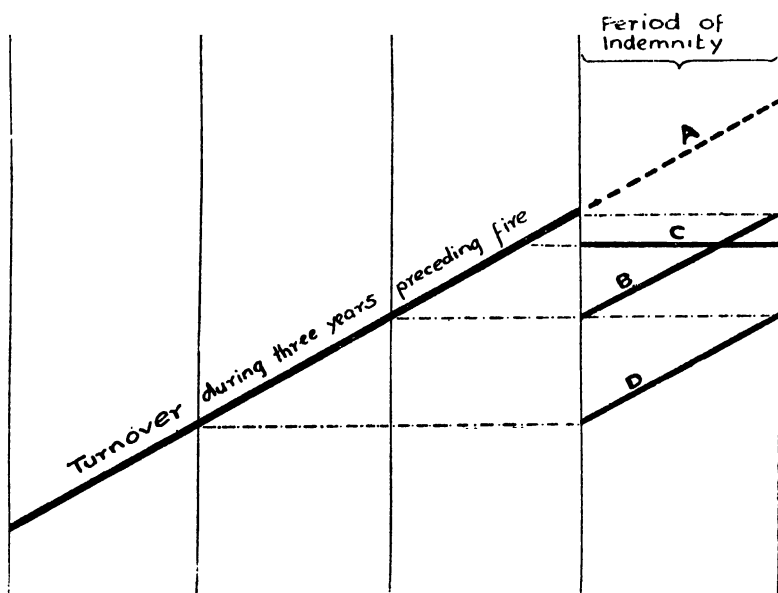


FIG 8

the continuation of the line representing the turnover of the past. A comparison of the turnover actually maintained during the period of indemnity with that standard will correctly represent the shortage.

If, however, other forms of policy had been issued, the standards they embody fall appreciably short of the turnover that might normally have been expected. A policy based on the results of the previous year would adopt the standard shown at *B*. An annual equivalent policy based on the average monthly turnover of the six months before the fire would provide for the measurement of shortage from the line *C*. The average turnover of the three preceding years (*D*) would provide a standard absurdly below that

which might reasonably have been expected. Each of these forms of policy, however, would yield satisfactory results in the circumstances for which they are intended, and the importance of issuing a suitable form of policy will thus be realized.

Departmental Policies.

In connection with those businesses which are conducted on a departmental basis, such as large retail emporia and the like, it is not unusual to issue special policies which provide for the localization of loss measurement to the department or departments, the business of which is actually affected. By this means it is possible more accurately to register the actual loss of business directly caused by *fire*, for it is only to be expected that ordinary conditions of business may bring about certain fluctuations of turnover in the departments which are in no way interfered with after a fire. If, then, we were to measure shortage of turnover over the business as a whole, including the trading of departments obviously *unaffected* by the fire, the real loss of business properly attributable to the fire might be hidden or aggravated. The "Departmental" policy, a copy of which is given at Appendix IX, is drawn to provide for the measurement of loss *by departments*, instead of over the business as a whole, as is done under the ordinary form of policy.

The word "affected," of course, does not necessarily mean that the stock or premises of the department concerned was actually damaged by fire. Loss of custom in one department may cause loss in other departments, or, it may be, for instance, that a part of the space usually allocated to Department *A* is, during the period of indemnity, placed at the disposal of Department *B*, whose stock was destroyed by fire. In that case it might be expected that the business of Department *A* would suffer in consequence, and so both departments would be regarded as "affected" by the fire, and the shortage of turnover in both would be measured under the system outlined in the policy.

It is usually only practicable so to departmentalize the measurement of shortage in *turnover*, for there are difficulties in the way of definitely determining the actual net profit of any particular department, seeing that separate profit and loss accounts are not always prepared in respect of each separate department. Consequently

the percentage recoverable on the shortage of departmental turnover is sometimes governed by the normal percentage of profits to turnover of the business as a whole. If, however, departmental Profit and Loss accounts are kept, enabling a separate sum to be issued in respect of each Department, policies can be adapted to provide for the payment of the appropriate departmental percentage on any shortage in Turnover.

Warehouse and Shops Policies.

One other form of turnover policy should be noted. It is known as the " Warehouse and Shops " policy, and it is designed to meet the requirements of that type of business which consists of a number of retail establishments, all of which depend for their supplies on one or more central warehouse. Many multiple shop firms maintain a large warehouse from which the various branches are supplied with goods, thereby enabling the firm to centralize its buying operations and maintain adequate stocks. The effect of a fire in connection with such a business may thus be local or general, according to whether the fire occurs at a branch or at the central warehouse. In the former case, the result will be a falling off of business at the branch concerned. A comparison of the turnover of the branch during the period of indemnity with that of a normal period before the fire will enable the shortage to be measured. But if the fire occurs at the warehouse, the result is likely to be that the turnover of *all* branches is affected. The warehouse itself has no turnover, either before or after the fire. The goods it sends out are doubtless debited to the branches concerned at a certain price, probably somewhat in excess of the actual wholesale purchase price, but the difference is in no sense profit, seeing that no sale has in reality been effected. No real profit accrues to the business until the goods have been converted into turnover at the branch counters. Whilst the warehouse receives no turnover, its existence is necessary to enable the branches to maintain theirs. Two definite systems of measurement are, therefore, necessary to meet the requirements of such a business; one to come into operation in the event of a fire at a branch, the other to apply if the fire should occur at the central establishment. This embodiment of a dual system naturally results in a somewhat lengthy

policy, which is reproduced in Appendix X. It provides, briefly, that in the event of a fire at a *branch*, the shortage in turnover at that branch shall be determined, and in the event of a fire occurring at the *warehouse*, the loss shall be measured by the falling off of turnover at *all branches*. On the shortage so established is payable the "Ascertained Percentage"—usually limited to the percentage of profits to turnover of the business as a whole—and, of course, some differentiation is necessary in the limitation of the Increase in Cost of Working, for a fire at one of the branches would not warrant so large an expenditure under this heading as would a fire at the warehouse. In connection with the former the amount is, therefore, limited to that necessary to maintain the "Branch Turnover." In the case of a fire at the warehouse, however,—involving as it does the turnover at all branches—the limitation placed on expenditure for Increase in Cost of Working is the amount necessary to maintain the turnover of the whole business.

The Sum Insured.

It will have been realized that, in connection with the various forms of policy that have been dealt with in the foregoing pages, the recovery by the Insured of his normal percentage of profits to turnover is dependent upon the adequacy of the sum insured, and it might now be convenient to consider how that sum insured should be arrived at. In the first place, it should be noted that, in all the forms of policy we have examined, the "Ascertained Percentage" makes provision for the comparison of the sum insured with an *annual* turnover. In the simple form of policy this is expressed as the turnover of the twelve months before the fire, but in the others some special method is embodied for fixing an appropriate annual turnover in conformity with general basis of loss measurement contained in the policy. For instance, if the policy is based upon results of the last three years' trading, the "Annual Turnover,"—against which the sum insured is compared to arrive at the "Ascertained Percentage"—is the average annual turnover for the three years preceding the fire. Each form of policy specifies what shall be regarded as the "Annual Turnover" for this purpose, and it follows that as the sum insured is to be compared with an annual figure, the sum insured must itself be an annual

figure if the result that is yielded by a comparison one with the other is to approximate the normal percentage of profits to turnover yielded by the business concerned. It is the *annual* profits that must be insured, even though the period of indemnity is less than twelve months, for any smaller figure would yield an "Ascertained Percentage" lower than the actual percentage of profits to turnover. The sum insured, then, for a period of indemnity limited to twelve months *or less*, should represent the annual amount of the net profit and specified standing charges. Such annual amount should, moreover, be calculated with due regard to the system of measurement outlined in the policy. If losses are to be assessed on the basis of the trading of the twelve months before the fire, then the sum insured should be the profits of the last financial year. If an "Increasing Business" policy is to be issued, such profits should be appropriately increased to provide for the anticipated expansion of business. A policy based on the average results of a given number of preceding years requires, as a sum insured, the average annual profits of the same period, and so on. It is to be noted, however, that where the period of indemnity *exceeds* twelve months, the sum insured should obviously be in excess of the amount of the annual profits, for a total stoppage of business throughout the maximum period would involve the Insured in a loss proportionately greater than the amount of his annual profits. A two years' stoppage would mean the loss of two years' profits, and so, when the maximum period of indemnity selected is longer than twelve months, it is necessary to increase the sum insured proportionately. For an eighteen months' period of indemnity the sum insured should represent one and a half times the annual profits; for a three years' period of indemnity, three times the annual profits, and so on. This, however, will naturally necessitate some revision of the policy wording, for we cannot compare a sum insured representing, say, three years' profits with an *annual* turnover, for that would give us a percentage three times as great as the normal earning capacity of the business. Some adjustment, too, will be necessary in connection with the setting up of the standard turnover against which shortage is to be measured for, if we are dealing, say, with a two years' period of indemnity, we cannot refer to "the period in the twelve months preceding the fire corresponding

with the period of indemnity." Such phraseology would be meaningless if the period of interruption or interference itself exceeded twelve months, and so it is necessary to adjust the usual policy wording in several respects when the maximum period of indemnity is longer than twelve months. The essential parts of a policy so amended to provide for an eighteen months period of indemnity is given in Appendix XI.

For convenience, the sum to be insured in relation to the length of the period of indemnity is given below in tabular form—

Period of Indemnity.	Sum Insured.
1 month	Annual profits.
3 months	
6 "	
9 "	
12 "	
15 "	1½ times annual profits.
18 "	1½ " "
21 "	1½ " "
24 "	twice " "
36 "	three times " "

In each case the "annual" profits should be computed with due regard to the nature of the policy and should be arrived at in a manner that will conform to the general basis of the policy.

Here it may be mentioned that, where a business is noticeably seasonal in character and a long period of indemnity is to be provided for, it is inadvisable that one should be selected which embodies a fractional part of a year, for it may be that when the fire occurs, such period will be found to embrace, say, either *one* or *two* busy seasons, according to the time of the year at which the fire occurs. If, for instance, the busy season is from June to August, an eighteen months' period of indemnity would extend to cover two such seasons if the fire occurred in May, but would only include one season if the fire should happen in October. In such a case, a period of indemnity of twenty-four months is clearly indicated.

Net Profit or Standing Charges Only.

Insurances are sometimes effected to cover net profit only or standing charges only. It may be that no net profit is being earned and that the full insurable amount is thus represented by

the amount of the standing charges or such part of them as is being met by the earnings of the business ; or perhaps the Insured prefers, for some reason, to limit the insurance to one in respect of net profit only. In either event, no alteration of general principle is involved and the policy wording requires but little amendment, for it still becomes necessary to set up a standard of normal trade activity just as if profits (in the ordinary sense) were to be insured. In fact, the only essential difference would relate to the percentage payable on the shortage that is measured from the standard so set up. The word "profits," of course, would be inapplicable, and in the ordinary form of policy the definition of "Ascertained Percentage" would read—

Ascertained Percentage. The percentage of the sum insured to the turnover of the twelve months immediately preceding the fire, but not exceeding the percentage of the net profit (*or specified standing charges as the case may be*) in the last financial year preceding the fire to the turnover for that period.

No alteration will be necessitated in Clause (b) of the policy, despite the fact that the insurance is limited either to net profit or specified standing charges only, for the full insurable interest is, nevertheless, the total of the net profit (if any) *and* the amount of all standing charges of the business. An insurance in respect of any less figure is virtually an under-insurance (even though the net profit *or* specified standing charges be fully insured as such), and in that event any expenditure for Increase in Cost of Working would have the effect of benefiting both Insured and Insurer in proportion to their relative interests, and should, therefore, be shared accordingly.

CHAPTER VII

Accounts—Standing Charges—Net profits—Income Tax—Interruption risk
—Rating—Fines and Penalties.

THE previous chapter contained some brief remarks on the computation of the sum insured in connection with profits policies and this leads us naturally to a more detailed consideration of the various components of the "profits" to be insured. The term, as we have seen, means net profit and specified standing charges, and to arrive at an appropriate total it is necessary that the various items be first extracted from the accounts of the Insured. Only the "Trading" and "Profit and Loss" accounts need concern us, and, although it is not unusual for manufacturing concerns to subdivide their trading account to show separately the financial result of certain definite stages of their operations, we may confine ourselves to the simplest of examples, for it is no part of our purpose to deal in any sense with the subjects of book-keeping or accountancy.

Accounts.

We may assume, then, that the accounts before us are as shown on page 82.

We see that the charges on the debit side of the two accounts are very varied in character. From a Profits Insurance point of view we are interested only in considering the effect that a fire would be likely to have upon them, for in calculating the sum to be insured we need only take into account those which cannot be varied in amount proportionately to any reduction in turnover. Some of them will, unquestionably, be payable in full, irrespective of the amount of business done. Others, whilst they will cease entirely with the total cessation of business, would probably show very little diminution, if any, so long as the business was being conducted at all, and would certainly not be capable of reduction proportionately to the extent of any diminution of turnover. Some of the charges are governed entirely by the amount of business done, and can, therefore, be dismissed from our calculations, whilst in connection with others, it may be that considerations of expediency

TRADING ACCOUNT

<i>Dr.</i>	£	<i>Cr.</i>	
To stock at beginning of year	5,000	By sales	31,000
„ purchases	12,000	„ stock at end of year	9,000
„ wages	6,000		
„ gross profit transferred to profit and loss account	17,000		
	<hr/>		
	£40,000		£40,000

PROFIT AND LOSS ACCOUNT

	£		
To directors' fees	1,000	By gross profit from trading account	17,000
„ salaries	4,500	royalties	500
„ rent	500		
„ rates and taxes	150		
„ auditors' fees	100		
„ carriage	50		
„ interest on debentures . .	600		
„ lighting	50		
„ heating	30		
„ repairs	200		
„ bad debts	150		
„ depreciation	700		
„ advertising	300		
„ postages and stationery . .	150		
„ insurance premiums . . .	350		
„ sundry charges	200		
Net profit	8,470		
	<hr/>		
			7,500

must be taken into account, in that, although no legal liability may exist to continue payment, the dictates of prudence require that they shall continue to be met

Standing Charges.

Perhaps it will simplify matters if we consider the various charges, not in the haphazard sequence in which they appear in the accounts before us, but under the headings that have been indicated above.

We can regard *Directors' Fees* and *Salaries* in the first category, for they would, undoubtedly, require to be payable in full, irrespective of the amount of business transacted. By salaries, of course, we mean not only the remuneration of managers and executive officials, but also that of the general office staff and salaried

outside representatives. *Rent, rates and taxes* should also be insured. They can properly be regarded as standing charges, although it is true that in certain circumstances the first two may cease entirely after a fire or be substantially reduced in amount. If the premises should be seriously damaged by fire, it may be that, under the terms of the lease, liability for the payment of rent ceases, either forthwith or after a certain period of time. Similarly, the Local Authority may waive its claim to the payment of rates in respect of the period during which the premises are untenable, but these considerations are likely to arise only in the event of very serious fire damage occurring, and Clause (a) of the policy contains a proviso to meet the position then created. As previously pointed out, however, very serious diminution in turnover may be occasioned by fire damage which would certainly not be extensive enough to cause a cessation of rent or rates. Moreover, business might cease entirely as the result of the destruction of a part only of the premises, and in any event it is unlikely that, with the resumption of business after a fire in reinstated premises, the normal volume of trade would be regained forthwith, but the full amount of rent and rates would, nevertheless, be then payable. In order to ensure the recovery on any loss of business of the normal percentage of profits to turnover, it would be necessary to include both items in computing the sum to be insured.

It is not unusual to insure both rent and rates under a fire policy, and it would be well to consider in what respect the cover afforded by fire insurance differs from that of a profits policy. It is to be remembered that the amount recoverable in respect of rent and similar charges when insured under a fire policy is determined by the length of time during which the premises are rendered "untenable" by fire, and that the period during which it is recoverable is terminated when the premises again become tenable. In other words, compensation is based on the extent to which the Insured is prevented from *using* the premises. Under a profits policy, however, the amount recoverable in respect of rent and other charges is governed by the extent to which the Insured is prevented from *earning* those charges. He recovers on his shortage in turnover (subject to a full insurance) the percentage that his rent and rates bears to his normal turnover, and is so indemnified

to the degree that he fails to earn the amount of those charges, whether the period concerned falls in what is normally his busy season or his slack season.

Further items which can be regarded as insurable standing charges, in that they would continue to be payable in full, are *Auditors' fees, insurance premiums, and interest on debentures*. So, too, would *interest on all borrowed capital*, whether it took the form of bank overdrafts or other loans, in respect of which interest is payable irrespective of the amount of net profit earned. Dividends on the ordinary shares of a business undertaking—or, indeed, on its preference shares—would not fall in the same category, seeing that their payment is dependent upon the amount of net profit earned being sufficient to warrant it. From a Profits Insurance point of view, therefore, the dividends on such shares should be regarded as part of the net profit and would be insurable as such. Provision would thus be made for the payment to shareholders of the dividends they would ordinarily have received from the earnings of the business had the fire not occurred.

We now turn our attention to certain items of expense which would undoubtedly cease to be payable if business stopped entirely, but it is doubtful if, in the event of a partial stoppage of business, they could be reduced in proportion to the extent of the turnover lost. Among charges of this category we notice *Lighting* (unless lighting be done under contract, in which event it would be payable in full), *heating, postages, and stationery*. Whether such items should be selected for insurance would depend upon the nature of the business and whether, in the event of partial interruption of trade, the loss thereon (i.e. the increased ratio of such charges to turnover) would be likely to be sufficiently serious to warrant their inclusion in the insurance. The point is one for decision by the proposer, but unless it is anticipated that such charges can, for all practical purposes, be reduced proportionately in the event of a reduction of business, their inclusion is necessary if the policy is to provide a full indemnity.

Of the charges which would be likely to be variable proportionately to a reduction in business, we may note *Purchases and Carriage* (unless it involves the maintenance by the Insured of stables or the upkeep of motor vehicles, or is carried out for him under contract for

a definite term). Neither of these, therefore, need be insured, seeing that no loss will be incurred in respect of them. The same remark applies to *Wages*, except that considerations of expediency must arise in connection with this item. Apart from such wages as may legally be payable in lieu of notice (and this need not concern us at this juncture), the wage-roll *could* probably be reduced in accordance with the amount of work to be done, but it is to be remembered that the services of skilled employees cannot always be obtained at a moment's notice. It is important that, when the time comes to resume business, there should be a skilled staff available for employment, otherwise the period of interruption will be lengthened by the time necessary to obtain and train the necessary staff. If the skilled workpeople be dismissed on the occurrence of a fire, it is only to be expected that they will seek service elsewhere, probably with the Insured's competitors, and will not be likely to return when the Insured's business is restarted. It will be desirable, therefore, to provide for the payment of wages to skilled employees during the period of interruption, and the annual amount of such wages should, therefore, be included in the sum insured.

Similar considerations will apply to *Advertising*. Unless contracts have been entered into as regards advertising (in which event the contracts must be carried out irrespective of the amount of business done), it is probable that the amounts so expended *could* be reduced proportionately to the reduction in turnover, but it would obviously be inadvisable to do so. If publicity is important when a business undertaking is being conducted under normal conditions, it becomes doubly so when it is temporarily unable to meet its customers' wants, and so the proposer will be well advised to include the item in the insurance. *Repairs*, too, constitutes a charge which the insured could elect to discontinue whilst his business is stopped, and he need not necessarily continue to put aside amounts for *Depreciation*, but such buildings, plant and machinery as are not actually destroyed by the fire will continue to need repair and renovation, even though they are not being used to their normal extent, and will continue to depreciate in value. He will probably decide, therefore, to insure both items.

The sundry charges, if analysed, would probably be found to

comprise a number of items, such as *Telephone Rents*, which would undoubtedly continue irrespective of the amount of turnover maintained, and in order to obviate the specification in the policy of the numerous items likely to be included in the term "sundry charges," it is usual to include "*Miscellaneous Standing Charges*" up to an amount not exceeding 5 per cent of the total of the specified standing charges.

Of the charges embodied in the accounts before us there remains "*Bad Debts*." This cannot be regarded as a standing charge, seeing that if no business is transacted no bad debts can possibly be incurred. Any amounts that may be written off in this manner during the period of indemnity would presumably relate to sales effected before the fire, and as such they would not come within the scope of the cover afforded by a profits policy. Sometimes a business firm will create a fund for the stabilization of losses incurred through bad debts, and will contribute thereto an annual amount out of which such losses are met. This, however, is in the nature of a voluntary allocation of net profit, and it is not unusual for such contributions to be insured as a standing charge, under the heading of "Reserve for Bad Debts." Strictly speaking, the intention would be expressed more clearly in the policy if the item were qualified by the addition of the words "less bad debts actually incurred."

The more usual items of expense have been dealt with in the foregoing, and it would be well to recapitulate those which are most frequently selected for insurance.

Rent, rates and taxes.

Salaries to permanent staff and wages to skilled employees.

Interest on debentures, mortgages, loans, and bank overdrafts.

Directors' fees.

Insurance premiums.

Advertising.

Auditors' fees.

Lighting and heating.

Depreciation of buildings, plant and machinery not destroyed by fire.

Repairs.

Postages and stationery.

Miscellaneous standing charges (not exceeding 5 per cent of the total amount payable in respect of specified standing charges).

There may, of course, be other charges of a special nature in connection with any particular business which are insurable as standing

charges by reason of the fact that they will continue to be payable in full, despite a stoppage of business, or cannot be reduced proportionately to a falling off of business. Any charge which falls under that heading may be regarded as insurable but, as we have noted, the policy provides for an appropriate adjustment of the amount of indemnity if any of the insured charges should, in fact, cease after a fire.

Net Profit.

There remains the question of net profit, the annual amount of which must be added to the total of the specified standing charges in order to arrive at the sum to be insured.

It will be recalled that we are concerned only with "the profit arising from the trading of the Insured in respect of the business," and we must, therefore, exclude therefrom any receipts (such as interest on investments and, in the accounts we are examining, the £500 received as Royalties) which do not properly arise from the trading of the Insured. Such receipts would presumably be unaffected by a fire at the premises and there is accordingly no need to insure them.

At this juncture some consideration must be given to the subject of Income Tax, which is inseparably associated with that of net profit. Income tax is occasionally insured as a standing charge, but it will be obvious that such an item is clearly out of place among those annual charges which continue to be payable irrespective of the amount of business done. We do not, of course, refer to the amount of income tax payable under Schedule A, which is based exclusively on the rental value assessment of any premises that the Insured may own and occupy for the purpose of his business. The income tax to which we are referring is that payable under Schedule D on the amount of net profit earned by the Insured at his business. This cannot be considered as one of the charges which first have to be met (as is the case with standing charges) before any net profit is earned. If no net profit is earned, there is no liability to pay income tax under Schedule D. The tax is, indeed, a charge on the net profit of the business—not on the business itself, as are each of the standing charges. It is a charge which has to be met *out* of net profit, just as the payment of dividends on

ordinary shares is dependent on the existence of net profit. For the purposes of Profits Insurance, therefore, we must regard as net profit the surplus available after the payment of all outgoings, but *before* the deduction of income tax. The amount of that tax is, in fact, insured as net profit, and in this respect it is placed in the same category as all other allocations of net profit, such as partners' drawings, interest on ordinary and preference shares and the like. Indeed, it is convenient to regard income tax in the same light as the items just mentioned, for we can properly regard His Majesty's Government as a partner or shareholder in each profit earning business carried on in the country, in that a definite proportion of its net yield is payable to the authorities as income tax.

It follows that the sum insured, to be adequate, must include the amount so payable, otherwise the principle of average operates in respect of amounts incurred for Increase in Cost of Working. It is true that the position is not very clear with regard to income tax payable on amounts recoverable under profits policies. It is doubtful if such amounts would be regarded as taxable if the premium on the profits policy had not been admitted as a charge against the business and, to uphold the principle of indemnity, some safeguard must consequently be introduced to obviate the possibility of the Insured gaining, as the result of a fire, to the extent of the income tax which he would otherwise have been called upon to pay. A clause is frequently inserted in the policies to the effect that amounts recoverable in respect of income tax can be admitted only subject to the establishment by the authorities of the Insured's liability to pay such tax. If, however, the Insured enters into an individual agreement with the local Inspector of Taxes, as is commonly done, to bring into account for income tax purposes any amounts recoverable under the policy (the authorities on their part, admitting the premium payable as a charge against the business in arriving at the amount of tax payable), there is no necessity for the clause referred to, seeing that the position is then regularized.

Interruption Risk.

Having considered the manner in which the sum insured is to be arrived at, it will not be inappropriate at this juncture to glance

at the subject of underwriting and the system of rating which is to be applied to the sum insured in order to calculate the premium payable.

In the preamble of the policy it is stated that the insurance comes into operation if "the premises or property therein of the Insured shall be destroyed or damaged by fire and the business shall be thereby interrupted or interfered with." Whilst we must not overlook that Profits Insurance is essentially a form of fire insurance, in that it provides an indemnity against loss caused through fire, we must also bear in mind that a factor quite distinct from the physical fire hazard (namely, the susceptibility of the business to interruption) is likely to have a powerful effect upon the general desirability of any particular risk. This may be termed the "interruption risk," and it follows that a risk which is hazardous from a fire insurance standpoint, may sometimes be regarded favourably when judged solely from the point of view of its interruption risk. For instance, if a business is such that it can well be conducted from timber-built shed premises, the Insured is unlikely to go to the needless expense of brick or stone buildings. The fire hazard is, therefore, a somewhat heavy one, but from a Profits Insurance point of view we must not lose sight of the fact that, if any of these wooden buildings should be destroyed by fire, they could be rebuilt in much less lime than it would take to reinstate more substantial premises. True, the probability of a fire occurring and doing extensive damage is greater than if the premises were built of incombustible material, but the consequent interruption of business is, by reason of the construction of the building, likely to be limited in extent. There is thus introduced into the profits risk a favourable factor which in some degree will offset the heavy fire hazard. In other cases it may be that the interruption risk is appreciably heavier than the fire hazard. The whole process of manufacture may be liable to interruption through a small fire at certain vital points, and whilst the buildings may be modern and of fire-resisting construction, the machinery and stock (although it may not be particularly susceptible to fire damage) may, perhaps, be such that it can be replaced only with difficulty—possibly from abroad.

The factors which have a material effect upon the interruption

risk of a business are varied and it is not easy to summarize them concisely. There is a fascination in the study of interruption hazard, due, perhaps, to the fact that its problems are of the nature which call for imaginative speculation. Each particular trade presents its own points of hazard and each business in that trade is affected by different factors which tend to improve or accentuate the individual interruption risk.

We may, however, synopsise this aspect of our subject as follows—

The “ Interruption risk ” is the susceptibility of a business to interruption through fire. It is affected by—

(a) THE TIME NECESSARY TO MAKE GOOD THE FIRE DAMAGE.

It is to be remembered that we are concerned not only with the reinstatement of the building, but also the replacement of stock and re-erection of the machinery. If this last has to be specially designed or imported, the period of interruption may be greatly prolonged.

(b) THE POSSIBILITY OF MAINTAINING THE BUSINESS IN THE MEANTIME either

- (i) from temporary premises, or
- (ii) by arrangement with other firms.

(i) If a business is conducted from premises which have been specially built for its particular needs, the likelihood of suitable temporary premises being available in the event of fire is remote (e.g. theatres, cinemas and the like). Similarly, a “ catch trade ” business which depends almost entirely upon the prominence of the situation of its premises would not be likely to maintain its trade at the normal level in temporary premises less favourably situated. On the other hand, many businesses do not need premises of a special type ; nor need they be situated in any particular locality provided they are within reasonable distance of the area of their operations. In such cases we may reasonably anticipate that the business could be conducted from temporary premises without great loss of trade.

(ii) Certain businesses are not so liable to serious interruption, as it is possible, perhaps, for their work to be undertaken by other firms at additional cost. A firm using any secret process, however,

could not reasonably be expected to disclose it to other firms in the event of fire, even if the work were physically of a nature which could well be done elsewhere on behalf of the Insured.

(c) THE POSSIBILITY OF LOSS TO THE BUSINESS AFTER THE FIRE DAMAGE HAS BEEN MADE GOOD.

It does not follow—in fact it seldom occurs—that business will resume its normal level as soon as the fire damage has been reinstated. It may be, however, from the nature of the business that considerable time is likely to elapse before normal business conditions are resumed, seeing that large contracts or important customers are liable to be lost permanently as the result of stoppage (e.g. firms supplying parts to motor-car manufacturers).

It will be seen that the subject is one of some complexity, and whilst the interruption risk has considerable bearing upon underwriting, the factors affecting it are often of so indefinite a nature that it is impracticable to evolve a satisfactory system of rating which will take fully into account the various circumstances likely to have an effect on the extent of the interruption following fire. The position is largely met, however, by the fact that the Insured is able to select his own period of indemnity, thereby obtaining the advantage of a comparatively lower rate for his insurance if his business is such that a lengthy period of interruption is not to be anticipated.

The present practice is to rate Profits Insurances on the average fire rate payable on the contents of the premises included in the insurance. In certain trades, such as furniture store warehousemen, it is more convenient to base the profits rate on the fire rate applicable to the building, seeing that the insurances on contents are likely to fluctuate considerably in amount from time to time, and, in any event, it would be difficult to ascertain the total amount insured on contents, as such insurances would ordinarily be effected by persons other than the Insured.

Rates.

In rating profits risks, it is first necessary to arrive at the "basis rate," which term is applied to the average fire rate applying to the contents (or buildings, as the case may be) of the premises

to be mentioned in the policy. In arriving at the basis rate, it is usual to disregard short period fire insurances, and to take into account the total sum insured on contents under annual policies and the net fire premium payable therefor, after deduction of all discounts for appliances and the like. In connection with sprinklered risks, however, substantial rebates are usually allowed in addition to the discounts applicable to the fire rate, and it might here be noted that, where an extension of cover is required in respect of riot and civil commotion and the like, the basis rate is loaded by a figure somewhat in excess of the rate required for an insurance against loss by material damage from these perils. The reason for this is that the position in regard to the rights of recovery against the police authorities for profits losses caused by damage by rioters is by no means so clearly defined as it is in regard to the material damage so caused. Moreover, there is reason to apprehend that malicious damage by rioters and strikers would be directed towards such parts of a factory or warehouse as would be likely to cause the greatest dislocation of business.

Having calculated the appropriate basis rate, an adjustment thereof is made in accordance with the length of the period of indemnity selected by the Insured. For a three months' period of indemnity we at present take not less than 75 per cent of the basis rate ; for six months, 110 per cent ; and for twelve months, 150 per cent ; and the profits rate so arrived at is, as we have seen, applied to the *annual* profits. For longer periods of indemnity, as already stated, the sum insured must be proportionately increased, and, consequently, the rates for periods of indemnity of longer than twelve months tend to decrease as the length of the period increases. The minimum rate for a period of indemnity of 24 months, for instance, would be 125 per cent of the basis rate, and for 36 months, only 100 per cent, but when these rates are applied to the appropriate sums insured in each case it will be seen that the resultant premium is not inconsistent with the relative liability borne by the Insurer throughout the different periods.

Assume, for instance, that our basis rate is 4s. per cent and that the annual profits are £1,000. The appropriate premium arrived at by the application of our scale is seen to increase as the period of indemnity is lengthened—

Period of indemnity.	Rate.	Sum insured.	Premium.
Months		£	£ s. d.
3	3s. (75%)	1,000	1 10 -
6	4s. 5d. (110%)	1,000	2 4 2
12	6s. (150%)	1,000	3 - -
24	5s. (125%)	2,000	5 - -
36	4s. (100%)	3,000	6 - -

Naturally, the months which immediately follow the fire are the most hazardous from a Profits Insurance point of view. The later months in the longer periods of indemnity are not likely to prove so costly to the Insurer as are the earlier ones, seeing that they will be affected only following a serious interruption of business. Before the later months are reached it is probable that the steps taken to overcome the dislocation of business will have proved effective. On the other hand, it is to be expected that the trading of the earlier months will be affected whatever the degree of interruption, and it will be noted that the scale of rating makes due provision for the decrease of relative liability as the period of indemnity is lengthened. For instance, the charge for the first three months following the fire is one-half of that applicable to the whole of the first twelve months after the fire. Similarly, whilst the first twelve months carries a premium of £3, the second year of the period of indemnity involves an additional charge of £2, and the third an extra charge of £1 only.

Fines and Penalties

Provision is sometimes made in a profits policy for an indemnity in respect of fines and penalties for breach of contract. It may be that the Insured has certain contracts in hand, under the terms of which there is imposed a penalty for non-fulfilment by due date, and he seeks an insurance that will reimburse him for any such penalties that are incurred through a stoppage of work by fire. Similarly, he may wish to insure his liability to pay one or two weeks' wages to such workpeople as may have to be discharged after a fire. Such items are clearly not in the nature of standing charges, seeing that they are not ordinarily payable in the normal course

of business. Nor can they be regarded as items of increase in cost of working, for they are not incurred with the object of "maintaining the business," and thus minimizing the loss of profits. Any sums payable under either of these heads would therefore not be recoverable under a profits policy unless provision had been specially made for them, and when this is done they are dealt with under a separate section of the policy, a definite sum being allocated thereto over and above the amount insured in respect of profits. The wording usually employed for wages in lieu of notice is given at Appendix XII, and it should be noted that a rate of not less than five times the basis rate is applicable to the sum insured under these two items, quite irrespective of the period of indemnity applicable to the main profits insurance. The reason for this comparatively high charge is, of course, that the Insurer's liability in respect of these items is a heavy one, seeing that the whole of the sums so insured are likely to be payable as the result of a fire which actually causes only a short stoppage of work. The sums insured, however, would not be likely to be large, seeing that they would not represent *annual* figures but the actual amount of the penalty, or a week's or fortnight's wages as the case may be.

CHAPTER VIII

Units of activity other than turnover—Output—Input—Value of output—
Productive wages—Spindles and looms.

As indicated in a previous chapter, the amount of business transacted is not always measured in terms of turnover. To simplify our consideration of the principles of Profits Insurance, we have, however, hitherto confined ourselves to that index of trade activity, seeing that it is the one most usually employed. Moreover, it undoubtedly affords the most accurate means of determining the ultimate trading loss sustained, for net profit cannot be earned, and standing charges cannot be met, except from receipts accruing from sales. Goods or service must be exchanged for cash before profits are earned, and therefore turnover, constituting as it does the consummation of a business transaction, affords the most reliable measure of effective business activity. Nevertheless, it is not unusual, in connection with Profits Insurance, to gauge the relative activities of a business by other means. It may be more convenient to adopt some other index, closely related to ultimate sales to measure the extent to which business is affected as the result of fire. To illustrate the point, we will assume that a manufacturer annually purchases 1,000 yards of material, keeps five machinists fully employed, converts the material into 250 garments, sells them at £5 each, thereby earning £750 for net profit and standing charges. Obviously, the most reliable way to measure any falling off of business in such a case would be to compare the turnover after the fire with that of a normal period before the business was interrupted. If, however, this were found to be impracticable—for the reason, perhaps, that all record of sales had been destroyed and could not be approximated from any other source—the extent of the interruption could be ascertained by adopting some other index which would enable us to estimate the extent of the interruption. We could compare the number of garments completed by the Insured before and after the fire, and calculate that his loss is represented by £3 on every unit of shortage, for his £750 profits is earned by the sale of 250 garments. A more rough and ready means would be to compare the wages of the

machinists whose services were retained after the fire with the wage roll before the fire. The work of the machinists—as indicated by the amount of their wages—could be utilized to gauge the extent of the interruption, and we might assume that a 50 per cent reduction of wages indicated an output which was 50 per cent below normal, with a consequent halving of profits. Or we might calculate the earning power of his machines and assume that—working 50 weeks in the year—each machine earns £3 per week and base compensation on that weekly amount per machine for the period that it is put out of action through the fire. Again, we might go back a step farther and estimate the loss by comparing the length of material utilized before and after the fire. Each yard that is made up ultimately yields 15s. in profits, and so we see that activity can, if necessary, also be gauged by input or consumption of raw material.

Output.

For the purpose of Profits Insurance it is usual to adopt as the measure of trade activity the unit most convenient for the needs of the particular business concerned. Sometimes the records are so kept, or the nature of the business may be such, that its activity can best be expressed otherwise than in terms of turnover. There may be some other indication, closely and inseparably associated with its ultimate sales, which more rapidly registers any interference with business. A corn-miller, for instance, knows by the number of sacks of flour produced the volume of work being undertaken in his mill. A colliery manager will require frequent and periodical comparisons of the number of tons of coal raised to the surface; an electrical power undertaking registers daily the number of B.O.T. units generated. In such instances, and *wherever one standard commodity is produced*, it is practicable to base a profits policy on output—to measure loss of earning power by the shortage in production. The principle of the turnover basis is that each £ of turnover contributes a certain ascertainable sum towards the profits of the business. When we adopt output as a basis, we regard each *unit of output* as having a “profits” earning value. Obviously, then, the latter basis is not applicable to a manufacturer whose output cannot be expressed in one standard unit. A manufacturing confectioner, for instance, would be likely to make many

different types and grades of confectionery. The prices would vary considerably, and some lines would be much more profitable than others. The output basis would not be suitable in such a case, seeing that a partial interruption might affect either the most profitable or the relatively unprofitable side of his business. To reimburse him on the basis of the average earning value of each unit of output would obviously be unsatisfactory, and it should be noted that the output basis is only applicable where the main product of the business can be reduced to one common unit having a standard "profits" earning value. Any by-product, however, that may be turned out in conjunction with a main product will naturally vary in amount proportionately to any variations in the main output, and will, therefore, not disturb the general principle that each unit of main product earns a definite part of the profits.

A specimen of a simple output policy is given in Appendix XIII, and it will be seen that in general form and composition it is not dissimilar to a policy on the turnover basis. The unit of output is, of course, clearly defined in the policy, and the nature of the definition will naturally depend entirely on the business carried on by the Insured. If any particular standard of measurement is utilized by custom of the trade concerned, it is convenient to adopt the same unit for the purposes of the policy. For instance, the output of a brewer might be defined as "the output of malt liquors in barrels of 36 gallons." That of a flour miller might read, "The output of flour in sacks of 280 lb.," and so on. In order to establish the earning value of each of such units, and at the same time to introduce average to Clause (a) we must embody an appropriate definition to serve the same purpose as does the "ascertained percentage" in a turnover policy. Seeing that we are now to compare goods with money the word "percentage" is inapplicable, and so the somewhat forbidding term adopted is the "Ascertained Amount per Unit." This, in a policy based on the results of the past year, would read—

"The sum insured divided by the number of units in the output for the twelve months immediately preceding the fire, but not exceeding the profits in the last financial year preceding the fire divided by the number of units in the output for that period."

This definition, it will be noticed, is identical in principle with

that of the "Ascertained Percentage" in a turnover policy. In fact, the whole policy is comparable with a policy based on turnover, except that the profit-earning unit is deemed to be the *production* of something saleable, instead of the actual sale. Consequently, the provisions relating to increase in cost of working are to the effect that such increase in cost must be devoted to the maintenance of production—not to the maintenance of sales. As the extent of the company's liability is measured by the falling off of output, community of interest in regard to additional expenditure exists only in regard to those items of increase in cost that are incurred to minimize loss of *output*, and Clause (b) of an output policy is phrased accordingly.

It is to be noted that the different variations of estimated activity that we have already examined in a previous chapter can be expressed in a profits policy whatever unit we employ. We can, for instance, provide for an increasing business by utilizing the output or other basis in just the same way as when we employ turnover as the measure of activity. The *production* for a period prior to the fire is compared with that of the corresponding period in the previous year to establish the rate at which production is increasing, and, by applying such rate of increase to the production of the period in the preceding twelve months corresponding with the period of indemnity, we arrive at the output which might have been anticipated had no fire occurred, subject, of course, to due adjustment under the terms of Condition 5 of the policy.

Similarly, we can base the policy on the average production of a specified number of years preceding the fire and, in fact, give effect to all recognized bases of loss settlement whatever unit of activity be adopted.

To illustrate the application of the output basis, however, it will be sufficient to examine the working of the policy in relation to a simple loss based on the results of the previous year. For convenience, we have adopted figures similar to those that were used in illustrating the principles of the "ordinary" type of turnover policy

Sum insured	£6,000
Period of indemnity, 12 months.	
Profits of last financial year	10,000
Net profit and all standing charges last financial year,	12,000

A fire affects the business for six months.

Output for the period in twelve months preceding the fire corresponding with period of indemnity	Units. 2,500
Output during period of indemnity	700
	<hr/>
The shortage is thus	1,800

	Units.
Output for twelve months immediately preceding the fire	4,000
Output during last financial year was also	4,000

The "Ascertained Amount per Unit" is, therefore, the sum insured (£6,000) divided by the number of units in the output for the twelve months immediately preceding the fire (4,000), £1 10s.,

or, if less

the profits of the last financial year (£10,000) divided by the number of units in the output of the same period (4,000), £2 10s.

The "Ascertained Amount per Unit" (which is thus £1 10s.) applied to the shortage (1,800 units) gives us	£
The increase in cost of working is agreed at £1,000, but as the sum insured (£6,000) is less than the sum of the net profit and <i>all</i> standing charges of the last financial year (12,000) average applies and $\frac{6,000}{12,000}$ of £1,000 is recoverable under Clause (b)	500
	<hr/>
Total	£3,200

Input.

In connection with certain businesses (as, for example, sugar refineries) it is sometimes desired to base the insurance on production rather than sales, but the difficulty arises that the output is likely to be of different grades, each with a different profit-earning value. The better grades, which have perhaps been subjected to additional processes of manufacture or refinement, will naturally command a higher sale value. Each unit of the higher-grade commodity is, therefore, debitable with a larger proportion of the standing charges than those of the lower grades, and may, moreover, be expected to show a larger margin of net profit. As no standard unit of *output* exists, the output basis is inapplicable, but we have in the input (say of raw sugar) an index which has an intimate bearing upon production. It will be realized, however, that the ultimate profit-earning index is—and must be—the *turnover* of a business, seeing that profits are not actually earned until a sale is effected. Whilst convenience and expediency dictate that bases other than turnover shall sometimes be employed, it will be obvious that the farther back we go in the commercial process for our unit of activity,

the more we sacrifice accuracy of measurement, in that we take no cognizance of the factors relating to those stages which intervene between the process which gives us such other units of activity and the actual sales of the business. Moreover, the adoption of output or input as a unit of activity presupposes the ultimate sale of the commodity produced. It is based on the assumption that products will, in due course, be exchanged for money and that profits will be so earned. If, however, goods are being manufactured at a greater rate than that at which markets can be found for them—if, in other words, production exceeds demand—then neither output nor input will afford a satisfactory basis by which real loss of earning power can be measured.

Value of Output.

Where the nature of the business is such that neither its output nor its input is composed of one standard commodity, but where, nevertheless, it is desired to apply the general principles of the output basis (namely, that production shall furnish the standard of activity), the only common denominator to which the production can be reduced is the *sale value* of the output. It may be, perhaps, that a manufacturer turns out a variety of commodities, utilizing raw materials of a different nature and in varying proportions according to demand. The turnover of the business will, therefore, afford the most appropriate index, but, perhaps, although the process of manufacture is not susceptible to prolonged interruption, stocks are accumulated in such a manner that a shortage in turnover is not likely to manifest itself for some considerable period after a fire, and a long period of indemnity is thus indicated if the turnover basis is to be employed. In connection with such a business the Insured may elect to regard the *selling value* of his output as the basis upon which his activities are to be measured, seeing that the results of the fire will be reflected in the diminished value of his output much earlier than they would result in a falling off of turnover. A comparatively short period of indemnity will then meet his needs. In such cases the policy would be drawn throughout on the usual output basis, but the term "output" might be defined as—

The net trade selling value of the output of goods.

Productive Wages.

In those cases where neither turnover nor output is likely to afford a satisfactory basis for the measurement of activity because (as in the case of shipbuilders and heavy engineering risks), both sales and finished productions are made at varying and perhaps infrequent intervals, a basis sometimes adopted is the amount of wages expended on productive work. By productive wages is meant, of course, the wages paid to those workpeople who are actually engaged in the work of production. Salaries and wages paid to supervisory staff, as well as all non-productive wages (such as those paid to messengers and the like), are excluded from the wage-roll by an appropriate policy definition and the residue—the wages of employees engaged on actual production and directly chargeable to the prime cost of the Insured's manufactures—affords the index by which the activity of the Insured can be measured both before and after the fire. Each £100 of wages so expended is thus regarded as having a definite profit-earning capacity, and the ultimate loss of profits to the Insured is determined by the extent to which production—as indicated by the amount of wages expended upon it—is diminished as the result of fire. That complications are likely to arise will be evident upon reflection. The profit-earning capacity of wage expenditure is likely to be seriously affected after a fire. The output attained in a highly organized business as the result of a given wage expenditure may not be maintained when the business is being conducted in circumstances altogether abnormal after a fire, seeing that a certain amount of disorganization is only to be expected. Moreover, it may be necessary after a fire to vary the process of manufacture as a temporary expedient for the maintenance of production, as for example, by the substitution of manual labour for work ordinarily done by machinery. Here we have a definite overlapping with Clause (b), for the diminished earning power of such wage expenditure might, in certain instances, properly be regarded as increase in cost of working, and some adjustment of the post-fire wage roll would, obviously, be necessary in such a case if the Insured's loss of profits is accurately to be gauged by any variation in the amount of wages he pays. Again, it may be that work usually undertaken by the Insured is done on his behalf by other manufacturers during the period of indemnity.

Clearly, the Insured should not be entitled to recover under Clause (b) the additional cost of such work *as well as* the loss of profits indicated by the extent to which wages are reduced in consequence of such an arrangement, for the amount payable by the Insured to the manufacturer working on his behalf will include the amount which the latter expends on labour costs. This point arose in connection with a law case (*Booth v. Commercial Union*), and to meet it there is now usually embodied in productive wages policies a clause requiring that due provision shall be made, in connection with any diminution of wages after a fire, for such wages as would have been expended by the Insured on work (undertaken by other manufacturers during the period of indemnity) which he would ordinarily have done in his own factory.

A specimen policy on this basis is given at Appendix XIV.

Spindles and Looms.

As previously indicated, the number of machines of a given type in use is sometimes employed to measure the extent to which production is affected by fire, and this method is used particularly in connection with cotton and woollen mills. Each spindle—or each loom as the case may be—is deemed to have a definite profit-earning capacity whilst it is in use; and, having regard to the nature of the trades in question, it is usually found convenient to introduce a “time-loss” element into the insurances, and to assume that the profits, for the purpose of the insurance, are earned at a given rate per week. The relative number of spindles in use during each week of the period of indemnity as compared with the number in use at the time of the fire, is then utilized to gauge the degree of interruption and thus to determine the proportion of the weekly amount that the Insured is entitled to recover in respect of a partial stoppage. This weekly amount is known as the “Insured Amount per Week,” and it would perhaps be defined as—

$\frac{1}{52}$ nd part of the sum insured but not exceeding $\frac{1}{52}$ nd part of the profits of the last financial year immediately preceding the fire.

It will be noted that the definition embodies average and provision against over-insurance, as does the “Ascertained Percentage” in a turnover policy. The clause relating to the utilization of the number of spindles in use to establish the degree of partial

interruption would read somewhat as follows, but it is capable, of course, of a variety of adaptations to meet the individual requirements of any particular business of the type for which it is intended.

The Company will indemnify the Insured in respect of—

Loss of PROFITS sustained during the period of indemnity in consequence of such interruption or interference but not exceeding for each working week during which there are no spindles capable of being used the insured amount per week, nor for each week during which the number of spindles capable of being used falls short of the number of spindles in use at the date of the fire a rateable proportion of the insured amount per week.

Sometimes the policies make provision for the establishment of a definite "Ascertained Amount per Spindle" or loom as the case may be. Sometimes, too, where circumstances warrant the adoption of such a course, it has been found necessary to leave the contract entirely open as regards the earning power of the business, which would be stated in the policy as "the profits that would have been earned during the period of indemnity had the fire not occurred." No limitation is thus embodied on the basis of the actual results of the business during any particular period preceding the fire, and the amount of loss sustained has then to be determined in the light of the circumstances prevailing during the period of indemnity.

The variety of indices which are commonly utilized to measure loss of business activity demonstrates the adaptability of Profits Insurance, and the examples that have been cited in the preceding pages by no means exhaust the list of those employed. Any convenient and effective means of gauging the extent of business activity can be adopted. The proprietor of a nursing home may legitimately regard each patient in residence as an appropriate unit for the purpose of measuring his loss of profits due to fire. The insurance of a hotel-keeper might be based upon the number of bedrooms occupied; a warehouseman's policy might embody provision for the measurement of loss by the cubic capacity of space occupied for the storage of goods, and so on.

CHAPTER IX

Loss settlements—The assessor—Example of assessment under increasing business policy—Contribution with fire policy for loss of rent, etc.—Reduction of standing charges during period of indemnity—Assessment of losses when records destroyed—Conclusion.

IN previous chapters we have illustrated the arithmetical principles embodied in different types of policies by what have been termed for convenience "simple loss settlements." To show the intention of the policies we have taken hypothetical figures and utilized them to indicate how the system of measurement set out on the face of the policy works out when applied thereto. But because profits policies embody a pre-agreed basis by which losses are to be measured, it is not to be inferred that loss settlements are automatic and lacking in problems. It is to be remembered that the policies are essentially contracts of indemnity, embodying definite provisions for such adjustments as may be necessary in the light of circumstances actually prevailing before and after the fire. Whilst the policies outline the basis that shall govern the settlement, the application of that basis involves loss assessment principles not dissimilar from those appertaining to other classes of insurance.

To facilitate our consideration of this aspect of the subject it will perhaps be convenient to assume that an Insurance Company has been notified of the occurrence of a fire at the Insured's premises and of the fact that a claim will, in due course, be made under the policy.

The usual steps will, of course, be taken to ascertain whether the policy is in force and whether the premises at which the fire occurred are included in the premises mentioned in the policy.

The Assessor.

It is then a matter of importance that the company should be satisfied that everything possible is being done by the Insured to minimize the extent of the interruption of the business. If the fire damage is extensive, or if it appears that the interruption is likely to be a serious one, it is advisable that an assessor should be instructed to visit the scene of the fire at the earliest possible moment to confer with the Insured as to the best means to be

adopted to carry on the business with as little interruption as possible. At the same time the assessor will be able to form an opinion as to the probable extent of the loss, on which point the Company will naturally desire to have information.

It will probably be found that the anxiety of the Company to do everything possible to minimize the loss will be fully shared by the Insured, for valuable customers are liable to be lost for all time if their wants temporarily cannot be supplied. The Insured will not be slow to realize that any undue prolongation of the period of interruption will assuredly be reflected in the results of the business after the liability of the Company under the policy will have ceased. Consequently, he will be fully alive to the necessity of being "up and doing," but the presence of the assessor will often save valuable time at a juncture when the value of time is at a premium. It is possible that the Insured will hesitate—and rightly—to incur important items of increase in cost of working without the express sanction of the Company to such expenditure. He will wish, perhaps, to be assured that the steps he contemplates taking to keep his connection together are such as the Company would regard as reasonable and necessary within the meaning of the policy, and such matters can best be disposed of at a personal interview at the scene of the interruption as soon as possible after the occurrence of the fire.

It will be remembered that money cannot indiscriminately be expended under the guise of increase in cost of working, and that to be recoverable under the policy it must be—

- (a) necessarily incurred to maintain (not to increase) turnover or output,
- (b) directed towards the maintenance of turnover or output during (and not after) the period of indemnity,
- (c) applied to the reduction of the loss which would otherwise be payable under the heading of loss of profits, and
- (d) subject to average, i.e. shared between insured and insurer proportionately to the extent of the insurance in relation to the full insurable amount.

It will be part of the assessor's duty to place himself in communication with the office insuring the fire risk to ascertain whether and when liability is admitted for the fire damage. It may be that liability is not admitted by the fire insurance company, in which event, of course, the profits policy would not come into operation, but if, without admitting liability, the fire company were to make

an "*ex gratia*" payment for the fire damage, the Company insuring the profits risk would still retain its independence of decision, although it would probably be influenced by the same factors which guided the fire company and act in a like manner.

It has been assumed, of course, that the fire and profits risks are insured with different Companies. Where the same Company holds both risks, the matter is simplified, but in any event, it will be necessary for the assessor to satisfy himself that liability under the fire policy has been admitted in respect of a peril insured against in the profits policy. For instance, the fire policy may have been extended to include the risk of riot, under which heading liability may have been admitted for the material damage. If the profits policy had not been extended to include that peril, there would, of course, be no liability under the policy for loss of profits so sustained.

Inquiry should be made as to whether rent or other standing charge insured under the profits policy is also insured under any fire policy. If so, a question of contribution is raised which will be dealt with later.

The assessor will also take steps to ascertain whether there is in existence any other profits policy on the risk, and in this connection he should bear in mind the possibility of there being a percentage of fire loss policy covering the goods actually destroyed.

Throughout the whole period of interruption the assessor should keep in close touch with the Insured, and as soon as it is mutually agreed between the Insured and himself that the business has recovered from the effects of the fire, or when the maximum period covered by the policy has elapsed, he will require the Insured to furnish the figures necessary to put into operation the system of loss measurement outlined in the policy.

Increasing Business Policy Assessment.

The particular type of policy concerned will, of course, determine the nature of the statement the Insured will be required to submit. For our purpose we will assume that the policy is on the "Increasing Business" basis using turnover as the measure of trade activity, and that the sum insured is £10,000 (six months' period of indemnity).

It will be recalled that the increasing business policy provides

for the setting up of a standard of trade activity based on the maintenance of the rate of expansion shown by the business prior to the date of the fire. The first step in the ascertainment of the loss of profits sustained is the determination of the extent to which business has been lost as the result of fire, and so we must first calculate the amount of turnover that might reasonably have been anticipated had the business not been interrupted. To do this, the policy provides that the "Percentage of Increase" shall be ascertained, and we will assume that the necessary data is submitted as follows—

Turnover for the six months before the fire	£22,500
Turnover for the corresponding period in the previous year	£20,000

The "Percentage of Increase" is thus $12\frac{1}{2}$ per cent unless any adjustment is necessitated for the maintenance of the principle of indemnity. It may be that the turnover of either or both of the periods was abnormal, and that the assessor or the Insured can show that, owing to some special circumstance affecting trading conditions, an adjustment should in equity be made which would have the effect of decreasing or increasing the resultant percentage of increase. If so, it would be made, but assuming that none be necessary, the next step would be to ascertain the turnover during the period in the twelve months preceding the fire corresponding with the period of indemnity. We will assume that the period of indemnity of six months has been terminated by the expiry of the maximum period stated in the policy and that the business was, in fact, interfered with for a longer period.

The turnover for the requisite period in the preceding year would, perhaps, be given as £20,000. Unless this figure called for adjustment on the grounds that it was affected by some abnormal circumstance, it will require to be increased by the "Percentage of Increase" in order that there may be set up the standard against which shortage is to be measured, namely, the "Estimated turnover" as defined in the policy. By increasing the figure of £20,000 by $12\frac{1}{2}$ per cent we get, then, an "Estimated Turnover" of £22,500.

We now turn our attention to the turnover actually maintained during the period of indemnity. There is no point in detailing it month by month, although the Insured will probably submit it in that form. We are concerned only with the total for the

period, which is established at £7,500, and the shortage in turnover is therefore agreed at £15,000, there being no reason to think that any circumstance other than the fire contributed to the loss of business.

It now remains to determine what percentage of that shortage in turnover is recoverable by the Insured under Clause (a) of the policy

The Insured gives as his turnover during the twelve months immediately preceding the fire the figure of £50,000 from which we notice that the period of interruption coincided with the Insured's slack season, seeing that the turnover of the corresponding period of the previous year was only £20,000—well under half of the turnover for the twelve months preceding the fire. The business is, in fact, a seasonal one, and had the fire occurred at another season of the year, the loss of turnover would have been appreciably heavier.

The figure of £50,000 must also be increased by $12\frac{1}{2}$ per cent, as provided in the policy definition of "Annual Turnover," and this gives us £56,250. The percentage of the sum insured of £10,000 to this latter figure is 17·7 per cent, and it remains to be seen whether this percentage is higher or lower than the normal percentage of profits to turnover as disclosed by the accounts of the business concerned. The figures necessary for the establishment of this percentage are given as follows—

Profits in the last financial year	.	.	.	.	.	.	£10,000
Turnover in the same period	.	.	.	.	.	.	£48,000

and, as the percentage of the one to the other (20·8 per cent) is greater than that arrived at by the application of the sum insured to the annual turnover (i.e. 17·7 per cent), we are satisfied that the risk was not over-insured. The Insured has, in fact, omitted to increase his sum insured to make provision for his estimated expansion of business. He has contented himself with insuring only the profits of the last financial year, and average, therefore, applies, for we see that he recovers on his shortage in turnover only 17·7 per cent, whereas his normal ratio of profits to turnover is nearly 21 per cent.

The "Ascertained Percentage" can now be applied to the shortage in turnover, and this gives us—

17·7 per cent of £15,000	£2,655
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which is the amount recoverable under Clause (a) of the policy.

(The percentage has been worked to only one place of decimals for the sake of simplicity.)

We will assume that none of the specified standing charges ceased to become payable or was reduced in amount, and no adjustment of the above figure is thereby necessitated on that account.

As regards increase in cost of working, we will assume that the Insured produces evidence that, after making allowance for items which related to the period of interruption *after* the expiry of the Company's liability, the additional expenditure incurred to maintain the business during the period of indemnity amounted to £500. Each item is scrutinized and agreed, but we have already established the fact that the risk is under-insured. It must be borne in mind that the full insurable interest is the annual amount of the net profit and *all* standing charges (not merely those which have been specified in the policy), and we will assume that one item of the Insured's standing charges—say, interest on debentures—was not insured. The annual amount of this interest in the last financial year was £120. The full insurable amount on the basis of the last financial year was, therefore, £10,120, but this does not include the necessary allowance for the expansion of business which is taking place at the annual rate of $12\frac{1}{2}$ per cent, and we may, therefore, act on the assumption that the full insurable interest is—

£10,120 plus $12\frac{1}{2}$ per cent £11,385

We accordingly apply average to the amount expended for increase in cost of working on that basis, i.e.—

$\frac{10,000}{11,385}$ of £500 say £439

and agree the amount recoverable under the policy as—

Under Clause (a)	.	.	.	.	.	2,655
„ „ (b)	.	.	.	.	.	439
						£3,094

Apportionment of Rent, etc.

It occasionally happens that rent, and sometimes rates and taxes and debenture interest, are insured under both fire and profits

policies. Under fire policies such items are recoverable in proportion to the length and extent of "untenantability," whereas under profits policies the amount payable is determined by the loss of *earning power*. It is, therefore, most unlikely that a similar figure will be arrived at under both policies, and an interesting problem of apportionment arises.

Let us assume that under the fire policy there is recoverable an amount of £100 in respect of loss of rent, but by applying to the shortage in turnover the proportionate part of the profits sum insured which represents rent, we get an amount of £80 only. How is the insured loss of rent to be apportioned?

We must at once admit that the Insured is entitled to the higher figure of £100, for, although when measured by loss of earning power, this amount is higher than the amount of his actual loss, yet the Insured cannot be penalized by the fact that he has effected two insurances. Had his rent been insured only under the fire policy he would have recovered thereunder the sum of £100, and clearly this is the sum that remains to be apportioned between the two insurers.

The practice sometimes adopted is to share the *smaller* amount proportionately to the individual liability of the two policies, leaving the difference between the two amounts to be met by the policy with the larger liability. Taking the figures we have mentioned, this would give the following result—

Profits policy $\frac{80}{180}$ of £80	say 35 10 -
Fire policy $\frac{100}{180}$ of £80 :	say $\begin{array}{r} \text{£} \quad \text{s.} \quad \text{d.} \\ 44 \quad 10 \quad - \end{array}$
and balance up to £1	$\begin{array}{r} 20 \quad - \quad - \\ \hline 64 \quad 10 \\ \hline \text{£}100 \quad - \end{array}$

This system, however, manifestly penalizes *twice* the policy showing the higher liability. In the above instance, the fire policy is not only called upon to pay a higher percentage of the first £80, but is made to do penance a second time by paying the excess over £80. The initial difference of £20 between the amounts

independently payable under the two policies is increased in the final apportionment to nearly £30, and if the amounts varied to a greater degree than has been assumed—as well they might—the application of this system of apportionment might magnify the difference to an absurd extent.

It would not be difficult to calculate the proportion of the sum insured under the profits policy which relates to rent and arrive at an apportionment with due regard to the relative *sums insured* on rent under both policies.

Probably, however, the most acceptable method of apportionment would be to divide the *greater* amount on the basis of the relative individual liabilities of the two policies, which in the case we are assuming would give us—

Profits policy $\frac{80}{180}$ of £100	.	.	.	.	.	.	say	£	s.	d.
								44	10	—
Fire policy $\frac{100}{180}$ of £100	.	.	.	.	.	.		55	10	—
								£100	—	—

Cessation of Standing Charges.

It occasionally comes about that some of the standing charges insured under a profits policy cease to be payable after a fire or are reduced in amount. It will be remembered that there is a proviso in Clause (a) of the policy, reading—

Provided that if the amount of the specified standing charges shall be reduced the amount payable shall be reduced accordingly.

These words are included to emphasize the principle of indemnity, and they must, therefore, be interpreted from that standpoint. The intention is to prevent the Insured from making a profit in consequence of the fire, and that being so there would be no occasion to put the proviso into operation in respect of any standing charge that should happen to be reduced by circumstances other than those connected with the fire. If the reduction would in any event have taken place, then the Insured's net profit would automatically have been increased by the amount of such saving had the fire not occurred, and no adjustment of the amount recoverable would be necessary for the maintenance of the principle of indemnity.

For instance, the Insured may have included as one of his specified standing charges the annual amount of the pensions he paid to his

superannuated employees. If one of his pensioners were to die during the period of indemnity the saving would not be one which could properly be taken into account by the Insurer in reduction of the amount recoverable under the policy. Presumably the pension would have lapsed at this time had the fire not occurred, and the Insured's net profit would have been increased accordingly. The saving is one which would have come about in any event, and the Insured is entitled to benefit by the full amount.

But it may be that a loss has to be adjusted in consequence of a saving which is unquestionably brought about by the fire. Let us assume that a certain standing charge which normally amounts to £120 annually, ceases for one month during the period of indemnity in consequence of the fire. Here is a definite saving of £10 which has to be taken into account, and the most obvious method would be to arrive at the amount of loss in accordance with the terms of the policy, and then subtract therefrom the £10 saved by the temporary cessation of the charge in question. But this would be manifestly unfair if the risk were under-insured. In fact, it is just possible that in the event of serious under-insurance, the amount of the saving in standing charges might wipe out the amount otherwise recoverable under the policy.

A method not infrequently employed is to reduce the sum insured by the *annual* amount of the saving. The standing charge concerned is in effect struck out of the insurance and the sum insured adjusted accordingly. The ascertained percentage is thus correspondingly decreased and the reduced percentage is payable on the shortage in turnover. In the case we have cited the sum insured would be reduced by £120, which reduction would, of course, automatically be reflected in the ascertained percentage. The result would obviously be that the saving is shared between Insured and Insurer on the basis of the relative amounts of turnover *lost* and turnover *maintained*. If the turnover ceased entirely during the month in question, the Insurer would benefit by the saving to the extent of the full £10. If the turnover were halved during that period, the Insurer would benefit to the extent of £5 and the Insured would benefit to the same degree, seeing that the turnover he was able to maintain would be relieved of a certain charge which it would ordinarily have borne had no fire occurred. It accordingly

yields £5 more net profit than it would normally have done. It would appear, therefore, that this method does not give full effect to the principle of indemnity.

We must not lose sight of the fact that, for a definite period, a certain charge which ordinarily has to be met out of the earnings of the business has ceased in consequence of the fire. Consequently the turnover maintained will show a higher ratio of net profit than it would have done if the business had been working under normal conditions.

As the saving in standing charges is always determinable in actual *amount*, no purpose seems to be served in basing our apportionment upon the annual equivalent of such saving. It would seem equitable rather to regard any such saving in the light of *decrease* in cost of working due to the fire and to apportion it between the Insured and the Insurer in a manner similar to that employed in connection with Increase in Cost of Working, namely, on the basis of the sum insured in relation to the full insurable amount. If the sum insured be a full one, the policy provides the Insured with his normal ratio of net profit and standing charges to turnover. He is thereby fully indemnified in respect of his loss of turnover, and the whole of the actual saving can properly be regarded as accruing to the benefit of the Insurer. If under-insurance exists, it would be reasonable for the amount of the saving to be shared proportionately, the Insurers participating in the same proportion that they assume liability for increase in cost of working. This would appear to operate fairly whatever the extent of the interference.

Records Destroyed.

At first sight it would appear that the assessment of losses is practically impossible when books of account are destroyed by fire. It should be remembered, however, that most firms have their accounts audited by professional accountants, and the records in the custody of the auditors would probably be sufficient for the operation of the policy. In any event, it would, perhaps, be possible to arrive at the approximate amount of turnover made during any pre-fire period by reference to the Insured's bankers, for the takings would probably have been banked daily. It might well be, however, that the records appertaining to the business of

a small tradesman, for instance, might be totally destroyed by the fire, in which case it would be necessary to approximate as closely as possible the amount of turnover that would have been attained during the period of indemnity had the fire not occurred. As to the ratio of profits to turnover, it should not be difficult to determine the normal gross profit ratio of the trade in question, and from that information to arrive at the percentage of net profit and standing charges to turnover, seeing that the ratio is fairly well standardized among ordinary dealers in standard commodities. In the event of difficulty, however, it is probable that the amount of net profit shown to have been earned in the past could be established from the Insured's income tax return

Conclusion.

With this brief examination of the principles of loss assessments, we may conclude our survey of the field of Profits Insurance. Whilst an endeavour has been made to traverse the whole subject it has not been attempted thoroughly to explore any part of it. Indeed, it would be idle to claim that the last word had been said, or that finality had been reached in respect even of the least important phase of the subject, for, from its very nature, it is incapable of exhaustion by the mere presentation of figures and formulae. But true understanding consists, surely, of an appreciation of principles rather than a knowledge of facts.

Insurance has been described as the "handmaiden of industry," and no section of our business affords a better illustration of the aptness of the description than does Profits Insurance. It came into being to meet the need of industry; it has adapted itself to the increasing demands that have been made upon it and will assuredly continue to develop to keep pace with the march of progress.

APPENDIX I

USE AND OCCUPANCY INSURANCE

(BUSINESS INTERRUPTION INDEMNITY)

On the use and occupancy of.....

situated.....

Town of.....State of.....

and occupied for.....

The word "business" wherever used in this contract shall be considered and held to have the following meaning according to the class of property insured—

- (a) In a **manufacturing** property: "The production of goods."
- (b) In a **mercantile** property: "The sale of goods."
- (c) In **other classes** of property: "The carrying on of the business operations usual to the class."

If the said building, or machinery or equipment or stock contained therein be destroyed or damaged by fire occurring during the life of this policy so as to necessitate a total or partial suspension of business, this Company shall be liable under this policy for the **actual loss sustained** of net profits on the business which is thereby prevented, and for such fixed charges and expenses as must necessarily continue during a total or partial suspension of business, for not exceeding such length of time as shall be required with the exercise of due diligence and dispatch to rebuild, repair, or replace such part of said building, and machinery and equipment and stock as may be destroyed or damaged (commencing with the date of the fire and not limited by the date of expiration of this policy), under the following terms and conditions to wit—

During the time of a **total suspension** of business, liability under this policy shall not exceed the following amounts for each business day of such suspension—

For each business day from	to noon the following		
Aug. 15th	Sept. 15th	(inclusive)	\$10.00
.....	.....	(inclusive)	.....
.....	.....	(inclusive)	.....
.....	.....	(inclusive)	.....

During the time of a **partial suspension** of business, the per diem liability under this policy shall not exceed that proportion of the per diem liability which would have been incurred by a total suspension which the decrease in production (or business) bears to the full daily production (or business) at the time of the fire.

It is a condition of this insurance that the daily production (or business) at the time of the fire shall be based upon the average daily production (or business) for the period in the preceding calendar year corresponding to the period of suspension due to the fire.

It is a condition of this insurance that the Insured shall not be entitled to compensation on account of delay which may be occasioned by any ordinance or law regulating construction or repair of buildings, or by the suspension, lapse or cancellation of any licence, or for any other consequential damage.

It is a condition of this insurance that as soon as practicable after any loss, the insured shall resume complete or partial operation of the property herein described and shall make use of other property, if obtainable, if by so doing the amount of loss hereunder will be reduced, and, in the event of the Insured continuing business (in whole or in part) at some other location or using other property during the time occupied in repairing or reconstructing the property named herein, the net profits so earned shall be applied to the reduction of the loss, and adjustment shall be made as provided herein for partial losses.

APPENDIX II

EARLY FORM OF PROFITS POLICY

Loss of profit due to or arising out of fire which may interrupt or interfere with the usual course of the business of the Insured at the Insured's premises, as detailed in the proposal for this insurance. Said premises (as detailed in said proposal) are covered by ordinary fire insurance with the.....

Insurance Company for £..... over
at an average annual premium of.....shillings and.....
pence per cent.

Cash turnover for the purpose of this policy shall be held to be the cash receipts or takings of Insured in premises occupied by Insured.

In event of claim under this policy proof to the satisfaction of the Company shall be given of the following—

(a) The average cash turnover during the..... $\frac{\text{months}}{\text{weeks}}$ previous to the fire, hereinafter called the "Average cash turnover."

(b) The cash turnover $\frac{\text{month by month}}{\text{week by week}}$ after the fire, hereinafter called the "Actual Cash Turnover."

In calculating the average cash turnover, due allowance shall be made for any diminution due to previous fire or to a strike, lock-out, or other exceptional circumstances having a material effect, and in calculating the actual cash turnover, allowance shall be made for any exceptional circumstances which would in themselves have prejudicially effected the turnover.

The sum recoverable in the name of loss of profit under this policy shall not exceed the amount of this policy, and shall be.....per cent of the shortage between the said average cash turnover, and the said actual cash turnover and the said.....per cent shall be payable until such time (limited to.....months from the date of the fire), as the said shortage shall cease.

The premium on this insurance is subject to adjustment each period of insurance according to any difference between the average annual cash turnover for the.....financial year immediately preceding the date of the proposal for this insurance (and declared in said proposal to be £.....), and the cash turnover during the period of this insurance and the premium

on the said difference shall within fifteen days be paid by or allowed to the insured, according as the cash turnover for the period of this insurance may have exceeded or fallen short of the average cash turnover estimated in said proposal.

The sum insured under this policy for loss of profit shall not exceed the Insured's average annual trading or manufacturing profits, ascertained from his accounts, for the three financial years immediately preceding the date of the proposal for this insurance or (in the event of this insurance being renewed from time to time) the date of renewal of this insurance; said average profits being reckoned without deduction therefrom of interest, taxation, oncost wages, ground burdens, and of profits applied to meet depreciation, reserves and sinking fund. In the event of the said accounts being from any cause not available, the sum insured under this policy shall not exceed the average of the sums assessed upon the Insured for income tax for the three fiscal years immediately preceding the date of the fire.

APPENDIX III

PROFITS POLICY BASED ON RESULTS OF LAST FINANCIAL YEAR

This policy of insurance witnesseth that
(herein called the Insured), carrying on the business of.....
(herein called the business) in the premises situate.....
(herein called the premises) having paid to the.....
(herein called the Company), the first premium, the Company hereby agree with the Insured, subject to the conditions and definitions expressed in and endorsed upon this policy, and which are to be taken as part hereof, that if between theand.....or the last day of any subsequent period in respect of which there shall have been paid to and accepted by the Company the sum required for the renewal of this policy, the premises or property therein of the Insured shall be destroyed or damaged by fire and the business shall be thereby interrupted or interfered with.

The Company will indemnify the Insured and will make payments monthly at the option of the Insured in respect of—

(a) **Loss of profits** sustained during the period of indemnity in consequence of such interruption or interference but not exceeding the ascertained percentage of the sum by which the turnover of such period shall in consequence of such interruption or interference fall short of the turnover of the corresponding period in the twelve months immediately preceding the fire; provided that if the amount of the specified standing charges shall be reduced the amount payable shall be reduced accordingly.

(b) **Increase in cost of working** necessarily incurred by the Insured in consequence of such interruption or interference in order to maintain during the period of indemnity turnover not exceeding that of the corresponding period in the twelve months immediately preceding the fire; provided that if the sum insured by this policy shall be less than the sum of the net profit and all standing charges (insured and otherwise) of the business for the last financial year preceding the fire the amount payable shall be proportionately reduced.

Provided that the total liability of the Company shall not exceed in respect of any fire the sum which would be payable if the turnover were entirely stopped by the fire during the period of indemnity nor in the aggregate in respect of all fires during the annual currency of the policy the sum insured.

DEFINITIONS

In this policy the following expressions shall bear the meanings hereunder attached to them, viz.—

Profits. The net profit of the business added to the specified standing charges.

Specified standing charges (*as selected by the Insured*).

Turnover. The money paid or payable to the Insured for goods sold and delivered from the premises and from other premises occupied by the Insured for the purpose of the business during the period of indemnity and charges for work done.

Ascertained percentage. The percentage of the sum insured to the turnover for the twelve months immediately preceding the fire but not exceeding the percentage of the profits in the last financial year preceding the fire to the turnover for that period.

Period of indemnity. The period after any fire during which the business is interrupted or interfered with but not exceeding.....consecutive calendar months from the date of such fire.

Fire. Fire, lightning and explosion of gas used for light, heat or power and boiler and economizer explosion.

APPENDIX IV
POLICY CONDITIONS

1. The following expressions shall bear the meanings hereunder attached to them, viz.—

Financial Year. The year ending on the day to which in the ordinary course of the business the yearly accounts are made up.

Net Profit. The profit arising from the trading of the Insured in respect of the business in the premises after proper provision has been made for all standing and other charges all capital receipts and accretions and all outlay properly chargeable to capital and depreciation.

2. This policy does not cover loss occasioned by or in consequence of—

(a) Foreign enemy, riot, civil commotion, or any military or usurped power, earthquake,

(b) the destruction of or damage to property through its own fermentation or natural heating, or

(c) explosion except as otherwise herein stated.

Nor will the Company be liable for any loss under this policy unless the Insured's property destroyed or damaged by fire in the premises is insured against damage by fire and the Company or Companies by which such property is insured against damage by fire shall have paid for or admitted liability in respect of such damage.

3. The policy will be void

(a) In case of any misstatement or any misrepresentation of or any omission to state any fact material for estimating the risk whether at the time of effecting the insurance or afterwards, and whether in connection with the proposal or otherwise ;

(b) If, after the insurance has been effected, the risk of loss or damage by fire be increased through any cause whatsoever unless in every case notice shall have been given to the Company and the assent or sanction of the company been expressed by endorsement on the policy ;

(c) If the business be liquidated or permanently discontinued after a fire ;
(d) If any claim be in any respect fraudulent or if any false declaration be made or used in support thereof or if the fire was occasioned by or through the procurement or with the knowledge or connivance of the Insured.

4. On the happening of any damage by fire the Insured shall forthwith give notice thereof in writing to the Company and shall use due diligence and do and concur in doing all things reasonably practicable to minimize any interruption of or interference with the business and to avoid or diminish the loss and the Insured shall as soon as is reasonably practicable but in any event within thirty days after the expiration of the period of indemnity or such further time as the Company may in writing allow, deliver to the Company a statement in writing of any claim with all particulars and details reasonably practicable of the loss and shall produce and furnish all books of account and other business books, invoices, vouchers and other documents, proofs, information, explanations and other evidence and facilities as may reasonably be required for investigation and verification of the claim and, if required, a statutory declaration in verification of the particulars.

5. In adjusting the amount of indemnity account shall be taken of any variations in the business of the Insured and an equitable allowance made in the turnover for all extraordinary and other circumstances of the business.

6. The amount insured in respect of any standing charges specified in the policy shall only apply to the extent to which they shall have been or would have been met by the earnings of the business in respect of the period upon which the insurance is based.

7. If at the time of the loss there be any other subsisting insurance effected by the Insured or by any other person covering the loss or any part thereof, the Company shall not be liable to pay more than its rateable proportion of the loss.

8. The Insured and any claimant under this policy shall at the expense of the Company do and concur in doing and permit to be done all such acts and things as may be necessary or reasonably required by the Company for the purpose of enforcing any rights and remedies or of obtaining relief or indemnity from other parties to which the Company shall be or would become entitled or subrogated upon the Company paying any loss under this policy whether such acts and things shall become or be necessary or required before or after such payment.

9. All differences arising out of this policy shall be referred to the decision of an arbitrator to be appointed by the parties in difference or if they cannot agree upon a single arbitrator to the decision of two arbitrators one to be appointed in writing by each of the parties or in case of disagreement between the arbitrators to the decision of an umpire to be appointed in writing by the arbitrators before entering on the reference and unless and until the condition as to furnishing and verifying the claim has been complied with and an award has been made the Company shall not be liable for any loss and such award shall be a condition precedent to any liability of the Company or any right of action against the Company in respect of such claim.

Memo. Notice shall be given to the Company if the rate for fire insurance be increased.

APPENDIX V

INCREASING BUSINESS POLICY

The Company will indemnify the Insured and will make payments monthly at the option of the Insured in respect of

(a) **Loss of profits** sustained during the period of indemnity in consequence of such interruption or interference but not exceeding the ascertained percentage of the sum by which the turnover of such period shall, in consequence of such interruption or interference, fall short of the estimated turnover; provided that if any of the specified standing charges shall be reduced the amount payable shall be reduced accordingly.

(b) **Increase in cost of working** necessarily incurred by the Insured in consequence of such interruption or interference in order to maintain during the period of indemnity turnover not exceeding the estimated turnover; provided that if the sum insured by this policy shall be less than the sum of the net profit which would have been earned and all standing charges (insured and otherwise) of the business which would have been incurred during the annual currency of the policy had the business not been interrupted or interfered with the amount payable shall be proportionately reduced.

Provided that the total liability of the Company shall not exceed in respect of any fire the sum which would be payable if the turnover were entirely stopped by the fire during the period of indemnity nor in the aggregate in respect of all fires during the annual currency of the policy the sum insured.

DEFINITIONS

Estimated turnover. The turnover for the period in the twelve months immediately preceding the fire corresponding with the period of indemnity to which shall be added the percentage of increase.

Percentage of increase. The percentage shown by comparing the turnover for the six months immediately preceding the fire with the turnover for the corresponding period in the preceding twelve months.

Annual turnover. The turnover for the twelve months immediately preceding the fire to which shall be added the percentage of increase as defined in "Estimated Turnover."

Ascertained percentage. The percentage of the sum insured to the annual turnover but not exceeding the percentage of profits in the last financial year preceding the fire to the turnover for that period.

N.B.—Certain definitions common to all profits policies and appearing in Appendix III are omitted from the above and from those policy wordings which follow in the Appendices.

APPENDIX VI

ANNUAL EQUIVALENT POLICY

The Company will indemnify the Insured and will make payments monthly at the option of the Insured in respect of—

(a) **Loss of profits** sustained during the period of indemnity in consequence of such interruption or interference, but not exceeding the ascertained percentage of the sum by which the turnover of such period shall, in consequence of such interruption or interference, fall short of the estimated turnover; provided that if the amount of the specified standing charges shall be reduced the amount payable shall be reduced accordingly.

(b) **Increase in cost of working** necessarily incurred by the Insured in consequence of such interruption or interference in order to maintain during the

period of indemnity turnover not exceeding the estimated turnover ; provided that if the sum insured by this policy shall be less than the sum of the net profit which would have been earned and all standing charges (insured and otherwise) of the business which would have been incurred during the annual currency of the policy had the business not been interrupted or interfered with the amount payable shall be proportionately reduced.

Provided that the total liability of the Company shall not exceed in respect of any fire the sum which would be payable if the turnover were entirely stopped by the fire during the period of indemnity nor in the aggregate in respect of all fires during the annual currency of the policy the sum insured.

DEFINITIONS

Monthly turnover. The average monthly turnover for the six months immediately preceding the fire.

Annual turnover. Twelve times the monthly turnover.

Estimated turnover. The sum of the monthly turnover for a period equal in duration to the period of indemnity.

Ascertained percentage. The percentage of the sum insured to the annual turnover but not exceeding the percentage of the profits in the last financial year preceding the fire to the turnover for that period.

APPENDIX VII COMMENCING BUSINESS POLICY

The Company will indemnify the Insured and make payment monthly at the option of the Insured in respect of—

(a) **Loss of profits** sustained during the period of indemnity in consequence of such interruption or interference but not exceeding the ascertained percentage of the sum by which the turnover of such period shall in consequence of such interruption or interference fall short of the estimated turnover, provided that if the amount of the specified standing charges shall be reduced the amount payable shall be reduced accordingly.

(b) **Increase in cost of working** necessarily incurred by the Insured in consequence of such interruption or interference in order to maintain during the period of indemnity turnover not exceeding the estimated turnover ; provided that if the sum insured by this policy shall be less than the sum of the net profit which would have been earned and all standing charges (insured and otherwise) of the business which would have been incurred during the annual currency of the policy had the business not been interrupted or interfered with the amount payable shall be proportionately reduced.

Provided that the total liability of the Company shall not exceed in respect of any fire the sum which would be payable if the turnover were entirely stopped by the fire during the period of indemnity not in the aggregate in respect of all fires during the annual currency of the policy the sum insured.

DEFINITIONS

Monthly turnover. The average monthly turnover from the commencement of the business to the date of the fire.

Annual turnover. Twelve times the monthly turnover.

Estimated turnover. The sum of the monthly turnover for a period equal in duration to the period of indemnity.

Ascertained percentage. The percentage of the sum insured to the annual turnover but not exceeding the percentage of the profits from the commencement of the business to the date of the fire to the turnover for that period.

APPENDIX VIII

AVERAGE OF YEAR'S POLICY

The Company will indemnify the Insured and will make payments monthly at the option of the Insured in respect of—

(a) **Loss of profits** sustained during the period of indemnity in consequence of such interruption or interference but not exceeding the ascertained percentage of the sum by which the turnover of such period shall, in consequence of such interruption or interference, fall short of the average turnover of the corresponding period in the three years immediately preceding the fire ; provided that if the amount of the specified standing charges shall be reduced the amount payable shall be reduced accordingly.

(b) **Increase in cost of working** necessarily incurred by the Insured in consequence of such interruption or interference in order to maintain during the period of indemnity turnover not exceeding the average turnover of the corresponding period in the three years immediately preceding the fire ; provided that if the sum insured by this policy shall be less than the average annual sum of the net profit and all standing charges (insured and otherwise) of the business for the last three financial years preceding the fire the amount payable shall be proportionately reduced.

Provided that the total liability of the Company shall not exceed in respect of any fire the sum which would be payable if the turnover were entirely stopped by the fire during the period of indemnity not in the aggregate in respect of all fires during the annual currency of the policy the sum insured.

DEFINITIONS

Ascertained percentage. The percentage of the sum insured to the average annual turnover for the three years immediately preceding the fire but not exceeding the percentage of the profits in the last three financial years preceding the fire to the turnover for that period.

APPENDIX IX

DEPARTMENTAL POLICY PROVIDING FOR AN INCREASING BUSINESS

The Company will indemnify the Insured and make payments monthly at the option of the Insured in respect of—

(a) **Loss of profits** sustained during the period of indemnity in consequence of such interruption or interference but not exceeding the ascertained percentage of the sum by which the turnover of such period in the departments affected shall in consequence of such interruption or interference fall short of the estimated turnover in such departments ; provided that if the amount of the specified standing charges shall be reduced the amount payable shall be reduced accordingly.

(b) **Increase in cost of working** necessarily incurred by the Insured in consequence of such interruption or interference in order to maintain during the period of indemnity turnover in the department or departments affected not exceeding the estimated turnover ; provided that if the sum insured by this policy shall be less than the sum of the net profit which would have been earned and all standing charges (insured and otherwise) of the business which would have been incurred during the annual currency of the policy had the business not been interrupted or interfered with the amount payable shall be proportionately reduced.

Provided that the total liability of the Company shall not exceed in respect of any fire the sum which would be payable if the turnover in the department or departments affected by the fire were entirely stopped by the fire during the period of indemnity nor in the aggregate in respect of all fires during the annual currency of the policy the sum insured.

DEFINITIONS

Estimated turnover. The turnover for the period in the twelve months immediately preceding the fire corresponding with the period of indemnity to which shall be added the percentage of increase.

Annual turnover. The turnover for the twelve months immediately preceding the fire to which shall be added the percentage of increase.

Percentage of increase. The percentage of increase shown by comparing the turnover for the six months immediately preceding the fire with the turnover for the corresponding period in the preceding twelve months.

Ascertained percentage. The percentage of the sum insured to the annual turnover but not exceeding the percentage of profits in the last financial year preceding the fire to the turnover of that period.

APPENDIX X

WAREHOUSE AND SHOPS POLICY

The Company will indemnify the Insured and will make payments monthly at the option of the Insured in respect of—

(a) **Loss of profits** sustained during the period of indemnity in consequence of such interruption or interference but not exceeding

In the event of fire damaging or destroying the warehouse the ascertained percentage of the sum by which the general turnover of such period shall in consequence of such interruption or interference, fall short of the general turnover of the corresponding period in the twelve months immediately preceding the fire ;

In the event of fire damaging or destroying any shop the ascertained percentage of the sum by which the shop turnover of such period shall in consequence of such interruption or interference fall short of the shop turnover of the corresponding period in the twelve months immediately preceding the fire.

Provided that if the amount of the specified standing charges shall be reduced the amount payable shall be reduced accordingly.

(b) **Increase in cost of working** necessarily incurred by the Insured in consequence of such interruption or interference in order to maintain during the period of indemnity in respect of the premises damaged or destroyed turnover not exceeding that of the corresponding period in the twelve months immediately preceding the fire ; provided that if the sum insured by this policy shall be less than the sum of the net profit and all standing charges (insured and otherwise) of the business for the last financial year preceding the fire the amount payable shall be proportionately reduced.

Provided that the total liability of the Company shall not exceed in respect of any fire the sum which would be payable if the turnover in respect of the premises damaged or destroyed were entirely stopped by the fire during the period of indemnity nor in the aggregate in respect of all fires during the annual currency of the policy the sum insured.

DEFINITIONS

General turnover. The total turnover in all the shops.

Shop turnover. The turnover in the shop damaged or destroyed by fire.

Ascertained percentage. The percentage of the sum insured to the general turnover for the twelve months immediately preceding the fire but not exceeding the percentage of the profits in the last financial year preceding the fire to the general turnover for that period.

APPENDIX XI

EIGHTEEN MONTHS INDEMNITY

The Company will indemnify the Insured and will make payments monthly at the option of the Insured in respect of—

(a) **Loss of profits** sustained during the period of indemnity in consequence of such interruption or interference but not exceeding the ascertained percentage of the sum by which the turnover of such period shall in consequence of such interruption or interference fall short of the estimated turnover; provided that if the amount of the specified standing charges shall be reduced the amount payable shall be reduced accordingly;

(b) **Increase in cost of working** necessarily incurred by the Insured in consequence of such interruption or interference in order to maintain during the period of indemnity turnover not exceeding the estimated turnover; provided that if the sum insured by this policy shall be less than one and a half times the sum of the net profit and all standing charges (insured and otherwise) of the business for the last financial year preceding the fire the amount payable shall be proportionately reduced.

Provided that the total liability of the Company shall not exceed in respect of any fire the sum which would be payable if the turnover were entirely stopped by the fire during the period of indemnity nor in the aggregate in respect of all fires during the annual currency of the policy the sum insured.

DEFINITIONS

Estimated turnover. The sum of the turnover of the months in the twelve months immediately preceding the fire corresponding with the months in the period of indemnity.

Ascertained percentage. The percentage of the sum insured to one and a half times the turnover for twelve months immediately preceding the fire but not exceeding the percentage of the profits in the last financial year preceding the fire to the turnover for that period.

Period of indemnity. The period after any fire during which the business is interrupted or interfered with but not exceeding eighteen consecutive calendar months from the date of such fire.

APPENDIX XII

WAGES IN LIEU OF NOTICE

The Company will indemnify the Insured in respect of—

- Item I* (a) **Loss of profits** sustained
 (b) **Increase in cost of working** necessarily incurred by the Insured

Item II. Such sum as the Insured shall necessarily pay in respect of a period not exceeding two consecutive weeks in discharge of his liability for wages to employees (not employed by the Insured during the said weeks) in lieu of notice to terminate employment in consequence of such interruption or interference but not exceeding the sum of £..... per week nor in the whole the sum of £.....

The Insured hereby warrants that the sum Insured under Item II of this policy is not less than 1/26th part of the wages paid to employees (other than wages to skilled employees insured under Item I of this policy) for the last financial year preceding the fire.

APPENDIX XIII

OUTPUT POLICY BASED ON RESULTS OF PREVIOUS YEAR

The Company will indemnify the Insured and will make payments monthly at the option of the Insured in respect of—

(a) **Loss of profits** sustained during the period of indemnity in consequence of such interruption or interference but not exceeding the ascertained amount per unit on each unit by which the output of such period shall, in consequence of such interruption or interference, fall short of the output for the corresponding period in the twelve months immediately preceding the fire; provided that if any of the specified standing charges shall be reduced the amount payable shall be reduced accordingly;

(b) **Increase in cost of working** necessarily incurred by the Insured in consequence of such interruption or interference in order to maintain during the period of indemnity output not exceeding that of the corresponding period in the twelve months immediately preceding the fire; provided that if the sum insured by this policy shall be less than the sum of the net profit and all standing charges (insured and otherwise) of the business for the last financial year preceding the fire the amount payable shall be proportionately reduced.

Provided that the total liability of the Company shall not exceed in respect of any fire the sum which would be payable if output were entirely stopped by the fire during the period of indemnity nor in the aggregate in respect of all fires during the annual currency of the policy the sum insured.

DEFINITIONS

Output. The output of.....in units of.....

Ascertained amount per unit. The sum insured divided by the number of units in the output for the twelve months immediately preceding the fire but not exceeding the profits in the last financial year preceding the fire divided by the number of units in the output for that period.

APPENDIX XIV

PRODUCTIVE WAGES POLICY

The Company will indemnify the Insured and will make payments monthly at the option of the Insured in respect of—

(a) **Loss of profits** sustained during the period of indemnity in consequence of such interruption or interference, but not exceeding the ascertained percentage of the sum by which the productive wages of such period shall, in consequence of such interruption or interference fall short of the productive wages of the period in the twelve months immediately preceding the fire corresponding with the period of indemnity; provided that if any of the specified standing charges shall be reduced the amount payable shall be reduced accordingly.

(b) **Increase in cost of working** necessarily incurred by the Insured in consequence of such interruption or interference to maintain during the period of indemnity an expenditure in respect of productive wages not exceeding that of the period in the twelve months immediately preceding the fire corresponding with the period of indemnity; provided that if the sum insured shall be less than the sum of the net profit and all standing charges (insured and otherwise) of the business for the last financial year preceding the fire, the amount payable shall be proportionately reduced.

Provided that the total liability of the Company shall not exceed in respect of any fire the sum which would be payable if the business were entirely stopped by the fire during the period of indemnity nor in the aggregate in respect of all fires during the annual currency of the policy the sum insured.

DEFINITIONS

Productive wages. All wages to employees engaged in the business of the Insured whose wages are charged directly on to the prime cost of the Insured's manufactures.

Ascertained percentage. The percentage of the sum insured to the productive wages of the twelve months immediately preceding the fire but not exceeding the percentage of profits in the last financial year preceding the fire to the productive wages of that period.

In the event of the work which would normally have been undertaken by the Insured being carried on elsewhere on his behalf during the period of indemnity in arriving at the shortage in productive wages due allowance shall be made for wages paid to operatives engaged on such work.

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